United Nations A/CONF.226/PC.3/18

General Assembly

Distr.: General
13 June 2016

Original: English

Preparatory Committee for the United Nations Conference on Housing and Sustainable Urban Development (Habitat III)
Third session
Surabaya, Indonesia, 25-27 July 2016

Policy paper 5: Municipal finance and local fiscal systems*

Note by the secretariat

The secretariat of the United Nations Conference on Housing and Sustainable Urban Development (Habitat III) hereby transmits a policy paper entitled "Municipal finance and local fiscal systems", prepared by the members of Policy Unit 5.

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16-09554 (E) 070716

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Policy paper 5: Municipal finance and local fiscal systems

Executive summary

There is a strong, but often unacknowledged, national interest in ensuring productive urban economies, as they represent a disproportionate and growing share of nations' gross domestic product (GDP). Municipal governments oversee the provision of public goods and services to a growing majority of the world's inhabitants. Accordingly, improving the capacity of local governments to fund those services, and the transparency and accountability of the funding process, impacts the quality of life and level of citizen engagement in the political process. Steady economic growth requires properly financed and functioning municipal governments, supporting institutions, and infrastructure. Municipal finance is the operational fulcrum on which the success of ongoing future rapid urbanization rests.

Cities around the world face increasingly complex responsibilities, including, for example, responding to climate change. In many cities, this is complicated by chronically insufficient funding to meet local needs. Often, cities that face the most pressing problems also face resource and capacity constraints. These include, for example, cities in developing countries that require significant infrastructure investment to provide basic services to growing populations and expanding urban areas. They also include second- and third-tier cities (by population size), which represent almost double the share of national populations than megacities but receive significantly less attention from national Governments.

Across the world, municipal finance systems rest on the rules of the game (i.e. policies, constitutions, laws, and legislative frameworks) that comprise the following four key components: (a) expenditures; (b) revenues; (c) financial management; and (d) borrowing. The relative strength or weakness of these components determines whether a local government is able to deliver public goods and services to meet the basic needs and preferences of its population. It should be stressed that country circumstances, and the concrete characteristics of municipal finance systems within these five components, vary widely. In some countries, municipal finance systems function fairly effectively across all five dimensions. At the other extreme are countries in which systems and capacities are weak in all areas. An appraisal of the strengths or weaknesses of these components can help national, subnational, and local governments identify interventions that can improve the performance of their respective municipal finance systems.

Rules of the game. The key elements that enable or constrain the ability of local governments to manage fiscal health emanate from the "rules of the game", the statutes, policies, regulations, constitution, or common law that define a jurisdiction's powers and governance framework, coupled with the will and capacity of leaders to implement them. Formulating a New Urban Agenda that leads to a more prosperous, healthy, and equitable future for the world's municipalities begins by distilling core "rules" that have the potential to maximize a municipality's ability to link growth and development into a framework for sustainable governance and fiscal stewardship. National Governments can advance strong fiscal systems by: (a) increasing local government autonomy over taxes, revenues, and expenditures, particularly with respect to the collection of user charges and fees to cover expenditures; (b) enabling an intergovernmental relations framework where project execution is shared through arrangements with private and public sector

stakeholders, and public finance and planning functions are aligned; (c) supporting a strong system of intergovernmental transfers from higher levels of government for the general or specific use of localities; (d) authorizing local governments to leverage fiscal tools like municipal borrowing and land value capture to raise funds to support economic development and infrastructure; and (e) enabling localities to marshal resources that facilitate access to credit markets when they seek funds to support operations, maintenance, infrastructure financing, or service delivery to citizens. A key point here is that the rules of the game need to be clearly defined. In many countries, they are not, nor are they adhered to in practice. This needs to be addressed.

Expenditures. Economists have long argued that direct correspondence between the level of government responsible for providing a public service and the people who directly benefit from it will lead to a more efficient use of resources. Over recent decades, many countries have devolved a growing list of expenditure responsibilities to local governments, often without corresponding decentralization of resources to finance them. As a result, in both highly developed and in developing nations, one can find examples of municipal government failures to provide many services to residents and shortfalls in infrastructure and public service investments. In many countries there is a large difference between the local government expenditure share and the local government revenue share. This difference, often referred to as a fiscal gap, provides a very rough measure of the amount of intergovernmental transfers needed to assure that local governments have sufficient revenues to meet their expenditure responsibilities.

In municipalities where there is coordination among spatial and economic development planning and public finance, thoughtful and strategic investments can generate positive results for economic performance. Extending infrastructure and providing services to additional residents can expand the tax base and generate additional future revenues that support future expenditures and economic growth. However, the biggest expenditure challenge facing governments at all levels is the growing gap in infrastructure financing. Over the next 15 years, it is estimated that $93 trillion of infrastructure will need to be built globally, 70 per cent of it in cities. This will require annual investments exceeding 5 per cent of global GDP, consuming most of, or significantly exceeding, the tax revenues of subnational governments. New revenue sources will need to be found to take on this challenge. It is recommended that national and state/provincial governments expand intergovernmental transfers to municipal governments, enable local governments to raise new sources of revenues, for example, through land value capture instruments, strengthen local government accountability to residents, and motivate local governments to exploit scale economies by consolidating planning and expenditures at metropolitan rather than jurisdictional levels.

Revenues. Local governments rely on three basic pools of funds to manage their financial obligations: intergovernmental transfers, own-source revenues, and debt — the conversion of future revenues into current capital. Fiscal transfers from central governments are best used to provide access to capital for local investments in projects with large upfront costs. However, for the majority of cities around the world, fiscal transfers also cover a large share of operating budgets. The structure and character of the municipal grant system in any country matter a great deal for the way cities are managed, developed, and governed. The cost of allowing a fiscal transfer system to deteriorate, or not consolidating it sufficiently, is great,

particularly as cities come under increasing fiscal stress as a result of ongoing urbanization. It is recommended that national Governments ensure that aggregate transfer amounts are sufficient to cover or at least narrow fiscal gaps and that they take full account of any increases in the scope of the responsibilities of municipalities. The structure of the fiscal transfer system and the design of specific grants should expand the exercise of local expenditure autonomy guided by the principle that local governments should be allowed to determine expenditures in line with local needs to promote enhanced accountability and expenditure efficiency. Additionally, as discussed later in this paper, grant design needs to be strengthened to ensure greater equity in the distribution of grants across municipal jurisdictions.

The effectiveness of local revenue systems also relies on the quality of a diverse set of own-source revenue streams. Own-source revenues such as user charges and fees, property taxes and other land value-based revenues, and income and consumption taxes are essential for encouraging government efficiency and accountability. An appropriate portfolio of revenue sources needs to be developed based on the characteristics of the tax base and the capacity of local fiscal systems. Appropriate devolution of the authority to collect local taxes, to set rates, and to control assessments of tax bases can significantly improve overall effectiveness of local fiscal systems. National and subnational governments, thus, need to invest in both the technical and human resources sufficient to maintain effective local tax systems, ensure the coordination of own-source revenue collection, and enable proper administration of funds generated from intergovernmental fiscal transfers.

Financial management. Effective financial management systems enable local governments to plan, mobilize and use financial resources efficiently, and enhance transparency and accountability to stakeholders. Sound municipal financial management has two chief dimensions: a set of core, interlinked local government systems and processes that include planning, budgeting, accounting, procurement, reporting, auditing and oversight; and the ability of municipalities to steward their resources effectively and accountably so that they can meet their short- and long-term financial and operational obligations while maintaining accountability. Reform efforts should emphasize twin goals of strengthening the foundations of financial management and having municipal officials gain experience in practicing the basics before adopting sophisticated financial management tools. Priorities for the promotion of better local financial management can be grouped into four broad areas: strengthening municipal financial management systems and processes; improving transparency and accountability; enhancing monitoring and oversight of municipal finances; and building capacity. All of these activities are linked, and, as such, necessitate an integrated approach. Municipal financial management reforms should also be connected with national and state/provincial-level reforms of decentralization and public financial management. The role of the higher levels of government is critical. It should be clearly defined at the start and integrated with incentives at the local government level to best achieve reform objectives.

Borrowing. Access by municipalities to debt finance can be an important element of a broader strategy to plan and invest in urban infrastructure. Debt finance is not an additional source of revenue for municipalities; it simply converts future revenues into capital that is immediately available for investment by encumbering future revenues for debt service payments. Debt financing is feasible only where municipalities have the ability to service their debt from revenues in a sustainable manner and where a robust regulatory framework for municipal

borrowing is in place. There are two primary reasons for municipalities to access debt finance. The first is economic: the infrastructure built with the proceeds of debt will accelerate growth and generate productivity benefits that would not otherwise arise. The second concerns intergenerational equity: since the benefits of current investments will accrue to future generations, it is only fair that these generations pay for the investments through their contributions to the taxes and fees that will ultimately service the debt that finances them. Four factors are key in determining the size and character of municipal debt markets: intergovernmental fiscal transfer systems and own-source revenue structures of local governments; the nature and quality of financial management systems and the overall quality of urban governance; the depth and character of domestic capital markets; and the regulatory framework for municipal borrowing. Efforts to expand the flow of private credit into the municipal sector without creating a moral hazard must deal with core demand-side and regulatory constraints that affect these flows. This requires action at three levels: policy reform; capacity-building; and institutional interventions. The need for such action and greatest potential for good results lies in municipal markets in developing countries. Recent studies in these markets indicate that the primary challenges to increased private sector investment in municipal debt are not on the supply side: financial markets are often reasonably liquid, and there are substantial volumes of finance seeking medium- and longer-term investment opportunities. The core problem is that, given deficiencies in the four areas listed above, municipalities do not present themselves as borrowers that can be responsibly underwritten. It is proposed that the generic objective of action in this area should be to expand sustainable municipal debt markets where risk is appropriately allocated and properly priced, in countries where fundamental conditions permit it.

Climate finance. Nowhere are infrastructure decisions more critical than in cities. The planning and financing decisions made today will determine the world's climate and development outcomes for the next century. An analysis conducted for the 2015 State of City Climate Finance report suggests that more than 70 per cent of the $93 trillion in infrastructure that is needed over the next 15 years will be built in urban areas. This will require global annual investments of $4.5 trillion-$5.5 trillion in urban infrastructure, $0.4 trillion to $1.1 trillion of which will need to be spent on reducing the emissions and improving the resilience of urban infrastructure. With the right financing conditions, cities can lead the global community in implementing low-emission, climate-resilient projects to set in motion a societal transformation. Climate solutions should not merely include cities, but be born in and tested in them, capitalizing on their compact, connected, and climate-smart attributes.

Today's capital markets do not provide cities with adequate access to affordable financing suited to low-emission, climate-resilient infrastructure. The challenge is not simply to increase the amount of money in the pipeline, but also to create an enabling environment that encourages existing and new financing to flow from a broad spectrum of sources. Specific recommendations include the following: develop a financial policy environment that encourages cities to invest in low-emission, climate-resilient infrastructure; support cities in developing frameworks to price climate externalities; develop and encourage project preparation and maximize support for mitigation and adaptation projects; collaborate with local financial institutions to develop climate finance infrastructure solutions for cities; and create a lab or network of labs to identify catalytic financial instruments and pilot new funding models.

Public-private partnerships. Public-private partnerships (P3s) have been gaining popularity in the developing world, particularly for expensive public infrastructure projects. However, P3s should not be considered a panacea, nor are they a substitute for establishing more fundamental, but underdeveloped, public finance mechanisms that would be more appropriate for supporting public projects. P3s are appropriate only for a relatively small subset of public projects and should be viewed as a form of borrowing. Because the returns expected by private investors can be substantially higher than the costs of municipal borrowing, P3 projects need well-defined, self-generated revenues that are available to support these returns. Many governments encourage private sector participation through P3s, rather than simply financing a project themselves and contracting with the private sector to perform more specific tasks. While P3s are not a viable option for sidestepping the complexity and challenges of municipal finance to access lower-cost debt markets, they can be an important component of a complete portfolio of mechanisms available to support public projects. Even in the absence of a complete portfolio, P3s can sometimes offer an alternative for financing important projects in underdeveloped finance systems. It will be important to provide guidance to local governments to ensure that P3s are fit for purpose. National Governments should establish a P3 law or regulation to ensure clarity of government policy on P3s. This policy framework should set rules regulating the creation of P3s and rules regulating the ongoing operation and maintenance of the partnership. It would be helpful to support the development of some permanent advisory capacity, such as centralized national P3 units, to support municipalities pursuing P3s.

I. Vision and framework of the policy paper's contribution to the New Urban Agenda

1. Sound fiscal performance of local government is fundamental to the achievement of the New Urban Agenda, and the stakes are high. Nothing less than the environmental, social, and economic future of our planet hinges on our ability to manage inexorable global urbanization. The fiscal health of cities is a necessary condition for managing our global urban future. Fiscal health enables local governments to invest in the social and economic infrastructure that supports a higher quality of life, sustains economic growth, and helps localities prepare for and mitigate the effects of natural and financial crises.

2. Municipal finance is not a strictly technical issue, governed by the mathematical rules of accounting. Achieving municipal fiscal health presents more complex and nuanced challenges. The design of municipal finance systems can have a significant impact on equity, both within a single city and across a nation's cities. How revenues are raised and how expenditure responsibilities are defined and implemented can exacerbate or alleviate social, political, gender, and economic inequality, and access to human rights. In this regard, municipal finance systems offer an opportunity to affirmatively address national historic legacies of economic and social exclusion of disadvantaged groups.

3. Achieving municipal fiscal health is a collaborative effort. It requires the active participation of government at all levels — national, provincial, and local. It requires cooperation among individual jurisdictions within metropolitan regions, as modern infrastructure necessitates regional planning and investment. It also requires coordination among spatial planning, economic development policy, and municipal finance systems. The planning and policy decisions we make today will determine whether future generations can afford the world they inherit, just as policy and planning decisions a half-century ago promoted the sprawling urban development that presents us today with unprecedented financial challenges.

4. While rapid urban growth presents significant challenges, it also generates new opportunities. For example, the public investment in infrastructure that enables urbanization also leads to significant increases in the value of land. New revenue sources that capture these land value increments are being used increasingly by municipal governments to finance infrastructure investments. Proper use of land value capture tools to buttress the property tax, which is a bulwark of local revenues, helps create and maintain sustainable and fiscally healthy communities. Another opportunity is arising in carbon markets that are emerging to promote reductions in greenhouse gas emissions and offer an important new revenue opportunity for city governments. Cities can capitalize on the benefits generated by lower per capita greenhouse gas emissions of urban populations and the increasing benefits offered through better urban designs that reduce vehicle miles travelled or improve the energy efficiency of buildings.

5. The acceleration of global urbanization is a fact of recent human history. It has generated many challenges, and it has spawned important achievements and ancillary benefits. In the last decade, we passed the point at which more than half of our population lives in cities. The new urban challenge will be qualitative and how we urbanize will become preeminent. This policy paper provides a framework for national Governments to promote the municipal fiscal health that is fundamental to

the achievement of more inclusive, safe, and resilient cities, as articulated in Sustainable Development Goal 11 and embodied in the New Urban Agenda. Sound fiscal performance of local governments is also necessary to realize climate change mitigation goals agreed at the COP21 Sustainable Innovation Forum.

6. To guide efforts to promote the financial health of local governments, this paper provides a general understanding of the relevant key issues, challenges, policy priorities, and guidance for implementing and monitoring policy recommendations in certain key components of municipal finance systems: (a) expenditures; (b) revenues; (c) financial management; and (d) borrowing. Additional discussion is offered for two special topics, climate finance and public-private partnerships.

II. Policy challenges

7. The "rules of the game" — the statutes, policies, regulations, rule of law, Constitution, or common law — that govern a particular jurisdiction, coupled with the will and capacity of leaders to implement them, enable or constrain local governments' ability to manage fiscal health. Accordingly, formulating a New Urban Agenda that leads to a more prosperous, healthy, and equitable future for the world's municipalities must begin by distilling the key challenges that exist and creating "rules" that have the potential to maximize municipalities' ability to link growth and development to a foundation of sustainable governance and fiscal stewardship.

8. Developing a universal method for classifying global legal and policy archetypes that have the potential to drive sound fiscal stewardship is difficult because it is impossible to generalize one jurisdiction's experience to a range of sociopolitical contexts.[1] For these reasons, this section of the paper begins by briefly summarizing the policy challenges that should be addressed in the following areas that comprise municipal fiscal systems: expenditures; revenues; financial management; borrowing; public private partnerships and climate finance.

Expenditures

9. As countries around the world become more urbanized, a fundamental policy challenge facing local governments is ensuring that residents have access to a full set of public services. In most countries, the set includes primary and secondary education, health care, social welfare, police and fire protection, potable water, electricity, sewage disposal, refuse collection, street maintenance, lighting, traffic management, public transportation, parks, and recreational facilities. Without access to these services, not only will the well-being of city residents suffer, but cities will

[1] The examples presented throughout this paper are selected from case studies within jurisdictions with contrasting vertical and horizontal power-sharing arrangements, with varying degrees of fiscal, administrative, and public sector decentralization, and with political histories ranging from democratic stability to fragile new States emerging from a history of conflict and civil war. Policy implications originating from each are considered in the process of distilling select rules, policies, and laws that can engender strong intergovernmental fiscal relations and positively inform the creation of a New Urban Agenda. A broader survey of legislation relating to municipal fiscal health in developed and developing countries across the world is included in the policy matrix that appears as an exhibit 2 of the annex to this document. available at: https://goo.gl/Dw6grF.

fail to meet their potential as national engines of economic growth. While local governments in almost all countries are responsible for paying for public services such as refuse collection, fire protection, street maintenance, and traffic management, other services such as education, health care, and police are often funded by higher levels of government. The result is a great variation across countries in the role of local governments with respect to expenditures.

10. Over recent decades, for good and compelling reasons, many countries have devolved a growing list of expenditure responsibilities to local governments. Despite the potential benefits of decentralization, in a number of countries, provincial and central governments remain responsible for providing many public goods to city residents. This can result in delayed, uncertain, or inadequate delivery of services to urban residents. Central or provincial government employees are more likely to take a one-size-fits-all approach to service delivery and are less likely than local employees to understand local conditions or be accountable to local populations. Economists have long argued that direct correspondence between the level of government responsible for providing a public service and the people who directly benefit from it leads to more efficient use of resources (Oates, 1972). The challenge is evolving law and policy to manifest the benefits of greater decentralization. A decentralized system of government finance ensures that decisions concerning the provision of public services can better reflect local economic, social, cultural, and political conditions. Because local governments are closer to the people being served, decentralization also has the potential benefits of motivating citizen participation in fiscal decision making and enhancing the accountability of public officials to local citizens. This, in turn, builds a foundation for addressing issues of exclusion and inequality.

11. Around the world, in both highly developed and developing nations, one can find examples of failures to provide many services to residents. In many cities, the quality of the services delivered varies widely based on the spatial distribution of the population by race, ethnicity, or socioeconomic status. Examples include city schools with inadequate resources for their students, homelessness, traffic congestion, high crime rates, or many households living in informal settlements without access to potable water and other basic services. Because local government expenditures represent a big share of local economic activities, how revenues are spent can have important implications. Procurement practices can exacerbate or help to alleviate inequality and the economic or social exclusion of disadvantaged groups or different areas of a city.

12. Where there is coordination among spatial planning, economic development planning, and municipal expenditures, thoughtful and strategic investments can generate additional positive results for the economic performance of a city. Failures to provide services often reflect inadequate, inefficient, or ineffective spending, and shortfalls in infrastructure investment; challenges that must be addressed via policy. These conditions, when coupled with poorly planned sprawl development, add pressure to extend infrastructure networks inefficiently and generate significant long-term fiscal challenges for cities. Importantly, efficiently providing infrastructure and services to additional residents can expand tax bases and generate additional future revenues to support future expenditures and economic growth.

13. In a number of countries, poor levels of public services within cities can be attributed to the fact that expenditure responsibilities have been devolved to local

governments without a corresponding decentralization of resources to finance them, a prescription for poorly provided or non-existent services. The assignment of new public service responsibilities to local governments without consideration of how these new services will be financed must be addressed through policy. In most countries, municipal governments need explicit permission from either the national Government or provincial government to implement and collect a new tax or user fee. In some countries, such as South Africa, the assignment of revenue sources to different levels of government is prescribed in the constitution.

14. A local government's capacity to raise revenues also depends on its ability to administer and collect revenues, and on the magnitude of the economic base or economic activity that is being taxed. Data from the International Monetary Fund indicate that in some countries local government expenditures as a share of total government expenditures is approximately equal to the share of total government revenue that is raised by local governments. In many countries, there is a large difference between the local government expenditure share and the local government revenue share. This difference, often referred to as a "fiscal gap", provides a rough measure of the amount of intergovernmental transfers needed to assure that local governments have sufficient revenues to meet their expenditure responsibilities.

15. One of the biggest expenditure challenges facing governments at all levels is the growing gap in infrastructure funding and financing. Although little data exists to make careful international comparisons of infrastructure expenditure needs in developing countries, the Asian Development Bank estimated that Asian cities require infrastructure investments amounting to $120 billion. Another recent estimate, based on country data, suggests that, globally, urban public infrastructure needs will require annual expenditures of about 3 per cent of GDP for new infrastructure plus another 2 per cent for maintenance (Bahl and Linn, 2013). Importantly, local revenues in developing countries are not sufficient to meet these needs; as shown in exhibit 4 of the annex, subnational government taxes average only 2.3 per cent of GDP.

16. Inefficient spending patterns frequently occur because of the absence of coordination between land use and infrastructure planning and financial planning. In Cape Town, the national Ministry of Housing planned and financed the construction of low-cost housing without coordinating with the government of Cape Town. The result was that, motivated by the availability of cheap land, new housing was constructed in a remote location lacking adequate infrastructure and far removed from the location of jobs. There are many other examples of the consequences resulting from the lack of coordination between capital and operational spending. These include hospital clinics without nurses and medicine, and schools without teachers, and present policy challenges that should be addressed.[2]

Revenues

17. As municipalities face the challenges of providing public goods and services and maintaining public infrastructure, there is a strong need for them to strengthen three basic pools of funds to manage their financial obligations: intergovernmental

[2] The lack of coordination can mean, for example, that although money is spent on teachers and textbooks, students can spend years trying to learn in school buildings without electric power or with leaking roofs

transfers, own-source revenues, and debt, the conversion of future revenues into current capital. Each category of revenues identified carries its own unique public policy challenges that must be addressed in order to create the foundation for strong fiscal health.

Fiscal transfers

18. Fiscal transfers from central or state/provincial governments to municipalities exist in practically every country in the world with a functioning municipal system, and carry unique challenges that must be addressed in policy to set a strong foundation for municipal fiscal health. Their essential purpose is to bridge the gap between the cost of providing municipal services (i.e., expenditure assignments, or municipal mandates) and the revenues that municipalities are able to raise themselves to provide those services (i.e., revenue assignments). Within these overarching parameters, fiscal transfers may serve a variety of other purposes, including (a) achieving national policy objectives that require local government action, such as climate-mitigation or social-inclusion objectives; (b) compensating for fiscal disparities between municipal areas; and (c) enhancing the performance of municipalities in the execution of their responsibilities. In most developing countries, they are typically the most important source of municipal finance, and the materials in exhibit 6 of the annex provide an overview of fiscal transfers as a proportion of total municipal revenues for a number of countries in different regions of the world.

19. Funds transferred from central governments to local governments are best used to provide access to capital for local investments in projects with large upfront costs or to fund programmes with large recurrent costs, like public education. For most cities around the world, however, fiscal transfers also cover a large share of their operating budgets — a situation that often produces inefficiencies in service provision and limits the benefits of decentralization. Many different types of transfers can be found internationally, and each category of fiscal transfer carries unique public policy challenges. At the most general level, transfers include: (a) intergovernmental grants that are transferred directly to municipalities as cash; (b) non-grant transfers that take the form of an asset or an in-kind service; and (c) agency payments to reimburse municipalities for expenditures incurred on behalf of other levels of government. Shared taxes may also be considered a form of intergovernmental transfer, but this paper will focus on the policy challenges related to intergovernmental grants.

20. The most basic distinction in the realm of intergovernmental grants is between conditional and unconditional grants. A conditional transfer is earmarked for specific types of expenditure by municipalities and must be spent in accordance with prescribed goals and processes. An unconditional transfer has no such conditions attached, although it must be spent in accordance with existing standards and requirements for all public expenditures.[3] Whether transfers are conditional or unconditional, often, in developed and in developing countries, challenges arise when insufficient attention is paid to the ability of local authorities to comply with

[3] Such distinctions are often ones of degree. For example, "unconditional grants" often have some sort of condition attached to them, although these conditions may be much looser and less stringent than those relating to a grant earmarked for a specific expenditure (e.g., to fund primary education). Please see exhibit 5 of the annex for a typology of different types of grants.

grant provisions, and transfers are often not fully utilized because the institutional capacity is lacking within local governments offices.

21. Intergovernmental grants are a key source of financing for municipal governments. While grant-dependency in developed countries is normally lower, it is not uncommon for grants to represent more than 50 per cent of municipal revenue. There are wide variations among countries and it is difficult to identify any clear regional trends. The structure and the character of the municipal grant system in any country matter a great deal for the way in which the country's cities are managed, developed, and governed. Moreover, as the twin processes of urbanization and decentralization unfold, particularly across those regions that are still fairly early on in these processes (Africa and South Asia, for example), addressing the challenges in these systems will grow in importance.

22. In most developed countries, the basic structure of municipal grants is fairly stable, and in a number of countries, it is regulated or overseen by a more or less independent agency or commission (Australia, for example). Shifts in the overall allocation of fiscal resources to the municipal level or in the design and distribution of specific grants, are ongoing features of the budgeting process and can be controversial. Still, such changes tend to take place at the margin. Moreover, significant problems with the operation and functionality of the system (e.g., delays in the transfer of funds) tend to be fairly rare. The core challenges in developed countries that must be addressed in policy tend to concern adjusting the system to accommodate emerging issues or new policy priorities (e.g., developing grants to tackle environmental problems or climate change).

23. In developing countries, the challenges are more fundamental. Here, it is broadly possible to distinguish two different groups of countries. First, there are those where the intergovernmental fiscal system is still in a state of flux and consolidation, but where core problems are being steadily, if incrementally, dealt with to the advantage of municipalities. Typically, in such countries, aggregate fiscal flows to local governments have increased over time; local governments have substantial discretion over an increasing proportion of the funds flowing to them; new grants have been introduced to deal with emerging policy priorities; and the mechanics of the grant system are either solidly in place or becoming increasingly robust. The grant systems in these countries are by no means perfect, but the overall arc of the design and operation of the grant system has been broadly positive.[4]

24. Second are countries where the evolution of the grant system has been much less beneficial and presents a host of additional challenges that must be addressed in policy. Usually, this has involved some combination of declining real aggregate grant amounts; proliferation of grants with competing objectives or increased earmarking (hence, decreased fiscal autonomy for municipalities); adjustments to grant distribution formulas that penalize rapidly growing urban areas; an overly

[4] For example, in South Africa, national government transfers to local government have grown strongly in real terms since 2003-2004. This has led to a structural adjustment in the vertical division of resources between spheres of government. These new resources and improvements to the mechanisms through which funds are transferred have allowed the major transfer programmes to contribute significantly to the fight against poverty. Transfers are increasingly effective in targeting priority areas of poverty. A new generation of programmes, through encouraging infrastructure investment, is beginning to help municipalities meet the challenges of economic growth at the local level, as noted in the materials presented in exhibit 7 of the annex.

politicized approach to the allocation of fiscal resources that is both inefficient and inequitable; and chronic delays in the transfer of funds to the cities. A number of countries in sub-Saharan Africa have witnessed deteriorations in the design and performance of their municipal grant systems in recent decades. For example, after a number of significant improvements in the early years of decentralization, the intergovernmental grant system in Uganda has taken a steady turn for the worse. Between 2001 and 2012, aggregate flows to local government diminished from 5 per cent of GDP to 3.5 per cent, while the number grants more than doubled since 2000, almost all of them carrying strong earmarking.[5]

Own-source revenues

25. As municipalities face the challenges of providing public goods and services and maintaining public infrastructure, they need to develop a policy framework that supports strong and reliable local sources of revenue. Well-functioning local revenue streams strengthen autonomy and enable municipalities to be more responsive to local economic, social, political, and cultural needs. Own-source revenues can also strengthen civic engagement and government accountability — creating the fiscal framework for the social compact whereby citizens directly fund local governments to provide the public goods and services that define their quality of life. The effectiveness of local revenue systems relies on the quality of a diverse set of own-source revenue streams that include user charges and fees, property taxes and other land value-based revenues, and income and consumption taxes. There is a wide range of land-based revenue tools: public land procurement, exactions, betterment contributions, transfer or sale of development rights,[6] and land readjustments. There are stark differences among municipalities within countries and across countries in the composition of local revenue systems, in the quality of individual components of these systems, and in the quantity and efficiency of own-source revenue collection. Each component carries unique public policy challenges.

26. Around the world, local governments face a number of challenges that constrain their ability to raise own-source revenues. For example, constitutional, statutory, and policy limitations imposed by higher level governments on local government can constrain access to revenue sources or instruments and diminish local autonomy. Even when local governments are empowered to collect property taxes, higher levels of government often retain the power to set assessment

[5] Other countries in which the recent record has been mixed include India where grant flows to urban local bodies have increased but where significant grant programmes (e.g. the Jawaharlal Nehru National Urban Renewal Mission (JNNURM), the flagship programme of the Government of India in the urban sector with an estimated total capital expenditure needs of Rs 1,293 billion during 2007-2012) did not achieve its intended outcome. In Kenya, the newly decentralized constitution has been accompanied by significant flows to counties (20 per cent of total expenditure or 4 per cent of GDP in 2014), but the distribution of these funds has been characterized by a heavy anti-urban bias and cities have suffered as a result.

[6] In Brazil, CEPACs, a form of the sale of building rights, allow developers to build with higher densities within specially designated planning areas by buying a certificate that is sold in the local stock market. This system has appealed to developers because it is transparent and reliable. The certificates are tradable, and traded on secondary markets, although the city gets the revenue only from the first sale. The proceeds from the initial sale are used to pay for underground and other infrastructure needed to support redevelopment within the designated planning area.

parameters or tax rates.[7] Revenue collection can be negatively impacted by inefficiencies built into collection systems, including generous amnesties and abatements, inconvenient tax billing systems, and long delays in identifying delinquent taxpayers.[8] These issues weaken the ability of municipalities to assemble revenues that correspond to their obligations and weaken their ability to respond to changes in those obligations.

27. Technical and human resource capacities present another key challenge for local governments in the development of effective revenue collection systems, particularly in developing countries. Establishing and implementing local revenue instruments requires good systems and a cadre of skilled local public employees. Revenue management regulations are often inappropriate for country circumstances and local capacity and administrative systems. In most countries, management systems are so rudimentary that it is difficult or impossible to project revenues for future years. Common problems include underdeveloped reporting systems and property registration systems, non-existent or inaccurate valuation mechanisms, and ineffective collection systems. Low levels of administrative capacity also can limit the ability to raise revenues. Local governments with low levels of economic activity often are limited in their ability to raise revenues, and city residents with very low incomes are unable to pay local taxes or fees. Unreported incomes or transactions in cash-based economies make collection of consumption or income taxes difficult. Poorly trained tax collectors and underdeveloped monitoring systems diminish the effectiveness of collections and open the door to graft and corruption. Low collection rates are often combined with high collection costs as a result of administrative inefficiency.

28. As most locally provided services directly benefit the local area and are capitalized into local property values, the property tax is a strong own-source revenue option. However, an effective property tax system requires capacity levels that challenge local governments but are integral to proper execution. Fair administration of the property tax depends on the accuracy of assessed property values, but local governments in developing countries often lack the capacity to assess and maintain accurate property tax rolls.[9] Informal or unreported real estate transactions undermine municipal ability to accurately value property, while the absence of basic structures like an address system complicate reporting efforts. In some cases, the cost of developing an appropriately sophisticated cadastre can outweigh the potential revenues produced by the property tax. Informality (sections of cities excluded from tax base and service provision) can have serious implications for maintaining and growing local revenue, posing challenges to the promotion and maintenance of comprehensive and equitable fiscal systems. In addition, within countries, there are wide disparities in the quality and coverage of property registration systems, especially between rural and urban areas. The experience of the property tax in the developing world has, thus, been mixed, with some success in the Baltic States, but less robust results elsewhere (Malme and Youngman, 2008; Ahmad et al., 2014).

[7] For example, in Mexico municipalities must submit their value maps to the State Government for approval, while in Colombia the national Government exercises fiscal oversight of municipalities (De Cesare, 2012).

[8] Multi-year backlogs in the city's enforcement of property tax delinquency contributed to Detroit's 54 per cent delinquency rate in 2014 (Sands and Skidmore, 2015).

[9] Currently, the majority of property tax collection occurs in metropolitan areas (Bahl and Linn, 2014).

29. Fees and charges are an important part of a diverse revenue system and also carry unique challenges that must be addressed in policy. User fees and other charges are often chosen for their political expediency, at the expense of more efficient and sustainable sources of revenue. Importantly, the collection of fees is built on two elements: (a) a "users pay" culture; and (b) administrative systems that control access and meter use of public services. Neither element is well established in many countries or localities. Generally speaking, user charges, like property taxes, cannot be levied at high enough rates to cover entirely the expenses of local urban governments and sometimes barely cover collection costs.

30. Finally, potential spatial competition from neighbouring localities can present a significant challenge. For example, high rates of local consumption taxes may lead to purchases being made in neighbouring jurisdictions or high direct taxes on businesses may result in businesses fleeing across municipal boundaries.

Borrowing

31. One of the biggest challenges encountered in the effort to establish effective municipal finance systems is getting municipalities to embrace the idea that debt finance is not an additional source of revenue. Debt simply converts future revenues into capital that is immediately available for investment, thus encumbering future revenues for debt service payments. Two important things follow. First, debt financing should not be seen or used as a means of closing fiscal gaps associated with ongoing expenditure responsibilities, or as a means by which central governments can relieve themselves of fiscal burdens deriving from such gaps. Fiscal gaps, if they exist, need to be dealt with in their own right through reassigning revenue sources or restructuring intergovernmental fiscal transfers. Second, debt financing is feasible only where municipalities have the ability to service their debt from revenues in a sustainable manner. Municipalities that suffer from significant revenue weaknesses or excessive indebtedness can confront deep, structural fiscal imbalances. These situations compromise municipalities' ability to function effectively and may accumulate to the point of posing significant fiscal risks for higher level governments. Above all, municipal borrowing should comply with the "golden rule" of local government budgeting: local governments should borrow only to finance capital investment and should not use borrowing to fund deficits on their recurrent budgets, inclusive of debt service costs. How best to create a policy framework that enables access by municipalities to capital markets and the debt financing that will allow them to plan and invest in urban infrastructure is a fundamental challenge.

32. The challenges of meeting urban infrastructure financing needs are extensive. Current global estimates put this in the range of $4.1 trillion to $4.3 trillion per year over the period from 2015 to 2030.[10] Clearly cities cannot pay for all of these requirements on an annual basis. Borrowing thus needs to play a role in meeting these financing needs. However, borrowing carries risks and challenges that need to be understood, managed, mitigated, and addressed in policy. In order to identify these policy challenges, this section first provides a brief survey of the wide range of experience with municipal borrowing internationally, from the sophisticated 150-year-old municipal bond market in the United States of America to the rudimentary

[10] For additional information, see *The State of City Climate Finance 2015*, City Climate Finance Leadership Alliance, 2015.

municipal development loan funds in low-income countries. It also identifies the challenges associated with further developing rudimentary markets. Before surveying these challenges, however, it is important to clarify what municipal debt finance is, and is not, and to establish the reasons why expanding access to municipal debt is important to development.

33. There are many different types of debt, and debt can be classified in many different ways. Possible classifications include by maturity (short- versus long-term); by term (variable versus fixed rate); by instrument (bond versus amortized loan); and by security (general obligation versus specific revenue pledge). Different classes of debt can, and should, be used for different purposes and may need to be regulated in different ways. For example, short-term debt, such as revenue anticipation notes, is often used to bridge the mismatch in timing between in-year revenue receipts and expenditure disbursement requirements. Short-term debt is valuable for this purpose, but short-term debt financing needs to be regulated to ensure that it does not end up funding, or disguising, longer-term budget imbalances.

34. There are two primary reasons for municipalities to access long-term debt. The first is economic: the infrastructure built with the proceeds of the debt is expected to accelerate growth and generate productivity benefits that would not otherwise be possible. The second concerns intergenerational equity: since the benefits of current investments will accrue to future generations, perhaps over 20 to 30 years, it is only fair that these generations pay for the investments through their contributions to the taxes and fees that will ultimately service the debt that finances them. Long-term debt financing may also have positive operating benefits for municipalities as it creates incentives for municipalities to prioritize their capital investments carefully and manage their finances prudently in order to attract investment on the most attractive terms. However, it is important to stress that these benefits are critically dependent on the nature of the municipal debt system that is established, and each system carries its own policy challenges that should be addressed for it to function properly. For example, if municipalities do not borrow within hard budget constraints, but are able to transfer their liabilities to higher levels of government while still benefiting from the proceeds, the disciplining effects of borrowing diminish greatly, and borrowing is likely to become unsustainable.

35. Broadly speaking, four key factors determine the size and character of the municipal debt market in any given country:[11] (a) the intergovernmental fiscal framework, particularly the fiscal transfer system and the own-source revenue structure of local governments; (b) the nature and quality of financial management systems and processes, together with the overall quality of urban governance, including the degree of fiscal discipline and willingness to meet debt service obligations; (c) the depth and character of domestic capital markets;[12] and (d) the regulatory framework for municipal borrowing, which comprises two areas of policy making that also must exist: ex ante regulation of municipal borrowing

[11] This is a general articulation of the chief factors; other matters may also be of importance. For example, for debt-financed projects with discrete revenue streams, the sufficiency of the revenue stream to cover the required debt service obligations will be of central importance.

[12] Arguably, international financing sources should also be taken into consideration. However, having witnessed a number of occasions where foreign exchange denominated liabilities created severe financial difficulties for subnationals; most Governments in developing countries do not allow local governments to take on foreign currency liabilities (e.g. South Africa and Brazil).

powers and procedures and ex post systems and procedures in situations where borrowing municipalities become insolvent and default on their debt service obligations.[13] In general, the first two factors determine the credit quality of a borrowing municipality and hence form the demand side of the borrowing equation.[14] The third factor forms the supply side. The quality of the regulatory framework, factor four, intermediates demand and supply. Given any level of municipal creditworthiness and any capital market structure, the regulatory framework determines the incentives, and hence, behaviours, of both lenders and borrowers as well as the impacts of municipal borrowing behaviour on other elements of the public sector (the budgets of higher level governments for example).[15]

36. With respect to these factors, it is possible to distinguish three broad categories of countries with respect to municipal borrowing activities and systems. Finding appropriate policy interventions to support and expand municipal debt markets in countries in each category is a challenge. At one end are countries with mature municipal debt markets and stable, highly evolved intergovernmental systems, including municipalities with clear and substantial revenue sources over which they have significant authority, sound municipal public financial management and accounting systems, well-functioning domestic capital markets, and a clearly articulated regulatory framework. The United States and Western European nations are examples. At the other end are countries in which all these elements are lacking, or undeveloped — typically low-income countries with very modest domestic capital markets and weak or unstable municipal systems, or where municipal borrowing is not permitted. Examples include most of sub-Saharan Africa, South-East Asia (Cambodia, Laos, Bangladesh, Sri Lanka), and Middle East/North African countries such as Tunisia. Where municipal borrowing has emerged in these environments, it has generally been from state-owned financial intermediaries, or from commercial banks on a short-term basis. In between the ends of the spectrum is a range of countries with developing municipal debt markets. Typically, these are middle-income countries with either mature (South Africa) or nascent (Viet Nam) domestic capital markets and local government systems at different phases of evolution. This category includes a wide range of countries with very different local

[13] For additional information please see Lili Liu and Michael Waibel, "Subnational Borrowing, Insolvency and Regulation" in Anwar Shah (ed.) *Macro Federalism and Local Finance*, World Bank, 2008.

[14] Note that, it does not follow that cities that have good credit will necessarily be able to borrow. Actual borrowing potential rests on the additional factors listed below. Conversely, cities with poor credit may be effective borrowers if, for example, they are able to get higher government guarantees.

[15] It may be noted that some of these factors tend to be more tractable than others, and policy actions and policy reform in certain areas may be driven by factors other than a concern for expanding municipal borrowing. For example, revenue assignments are a feature of the overall intergovernmental structure, and significant reform in this area is often slow and gradual, while procedures regarding the authorization of municipal debt may more easily be changed.

government and intergovernmental systems, such as Colombia, Brazil, South Africa, China, the Philippines, Indonesia, and Viet Nam.[16]

Financial management

37. Well-functioning financial management systems enable local governments to steward resources effectively, properly account for and report on the custody and use of public funds, expend their resources efficiently, and manage their finances to address their development priorities in a sustainable manner. Sound municipal financial management that achieves these aims has two chief dimensions. First, a set of core, interlinked local government systems and processes must be present. These include planning, budgeting, accounting, procurement, reporting, auditing, and oversight. Second, municipalities must be able to steward their resources (cash, assets, investments) in an effective and accountable manner so that they can meet their short- and long-term financial and operational obligations while maintaining accountability to citizens and stakeholders. In both developed and developing countries local governments face several challenges that often impede strong fiscal management and can be addressed in policy. The following are a few examples of such challenges:

38. *Weaknesses in planning and budgeting*. Local governments often lack the organizational capacity to implement sound financial management practices, including multiyear budgeting and capital investment planning, cash management, effective asset management, and timely maintenance. In addition, weak revenue forecasting and lack of budget preparation skills often inhibit the municipal budget preparation process. Limited consultation and citizen participation in the budgeting process can result in municipal budgets being out of touch with citizen priorities, impacting the sustainability of programmes and projects and lessening the extent to which programmes reflect principles of equality and equity.

39. *Weak accounting and reporting practices*. Municipalities in many countries often do not follow modern accounting practices (such as double entry and accrual accounting). Many still use cash accounting that results in fragmented recording of municipal financial transactions and in a less comprehensive picture of the municipality's financial position. The absence of common standards for financial reporting makes it difficult for stakeholders to understand the state of a municipality's finances or to make comparisons with other municipalities. As cities across the world try to improve their access to market sources of financing, weak accounting and financial reporting practices create problems of information asymmetry, preventing smooth access to capital markets.

40. *Inadequate use of information technology*. Accounting records are the primary source of financial information and modern information technology plays a critical role in compiling, recording, and managing accounting information in both the public and the private sectors. Many countries use applications such as the Integrated Financial Management Information Systems to manage their financial affairs. However, efficient municipal management using the Integrated Financial

[16] Reliable statistics about municipal borrowing levels in developing market countries are difficult to come by; such statistics are practically non-existent in undeveloped market countries (although in such countries municipal borrowing levels are naturally very low). The materials in several exhibits of the annex provide some additional information for a small sample of countries in these categories.

Management Information Systems is not the norm in municipalities in developing countries. Reasons for this include challenges in the design and procurement of such systems; lack of suitable interfaces between business processes and technology designs and weak integration across tiers of governments; weak human resource capacities; and a range of political considerations.

41. *Weak monitoring and oversight systems*. Higher levels of government have a critical role in monitoring municipal finances. However, lack of uniformity in financial reporting standards and practices and inadequate information systems constrain the efficient and timely compilation of municipal financial information, delaying analysis and monitoring of municipal finances. Weak municipal audit practices (e.g., no separation between financial and compliance audits, absence of municipal audit standards, and low capacity to carry out regular and timely audits) affect the reliability of municipal financial reports and provide limited assurance to stakeholders on the quality of municipal finances.

42. *Weak staff capacities*. Efficient municipal financial management is as much a function of staff skills and capacities as it is a function of systems. Although the demand for efficient and effective management of municipal finances has increased, the skills of staff managing this function have often not kept pace.[17]

43. *Disjointed reform efforts*. Municipal financial management reforms tend to be input-oriented with limited attention paid to results. A core challenge for any country embarking on municipal financial management reform is to ensure that the reform is designed and implemented in an integrated and results-oriented manner, supported by a strong legal framework that connects all elements of reform.[18]

Climate change

44. The infrastructure planning and financing decisions made today will determine the world's climate and development outcomes for the next century, and present significant public policy challenges that must be addressed. Taken together, these decisions will lead to the building of either low-emission, climate-resilient infrastructure that increases economic opportunity, or they will lead to more of what we have already, effectively locking the world into a carbon-intensive pathway with sprawling human settlements, hazardous pollution, and heightened vulnerability to climate change. Nowhere are infrastructure decisions more critical than in cities, which house half the world's population, consume 70 per cent of the world's energy, and release at least the same proportion of energy-related greenhouse gas emissions. At the current pace of urbanization, the world's cities will grow by 65 million inhabitants a year between 2010 and 2025. In India's cities alone, this massive growth will create new infrastructure demands equivalent to the entire current residential and commercial floor space of the city of Chicago. In China, in the same

[17] Civil service rules within the public sector can prevent the hiring and retaining of financial management professionals by municipalities. Inadequate systems for training and poor incentives for upgrading skills and competencies can prevent staff from acquiring or building up the necessary skill levels required.

[18] It can be helpful to have an integrated legal or policy framework that connects between the elements of reform. For example, the Municipal Finance Management Act (MFMA) in South Africa provided an integrated and coherent framework for municipal financial management reforms and capacity-building, which are further described in Exhibit 11 of the Annex to this paper.

timeframe, cities will add two-and-a-half times that amount of new construction per year. How the world feeds, houses, transports, and powers its cities, and builds new ones, will shape our collective climate future.

45. There is an unprecedented opportunity for cities to lead the world toward a sustainable future, but we must act fast. Over the next 15 years, roughly $93 trillion of infrastructure designed to be low-emission and climate-resilient will need to be built globally. Analysis conducted for the 2015 State of City Climate Finance report suggests that more than 70 per cent of this infrastructure will be built in urban areas. The value of infrastructure required in urban areas over the next 15 years could be greater than the $50 trillion value of all the infrastructure in the world today. Some $4.1 trillion to $4.3 trillion per annum will need to be spent on urban infrastructure just to keep up with projected urban growth in a business-as-usual scenario. An estimated $0.4 trillion to $1.1 trillion additional investment per year will be necessary to make this urban infrastructure low-emission and climate-resilient. With current estimates of climate finance totalling just $331 billion per year (inclusive of both urban and nonurban flows), the magnitude of the challenge for urban climate finance becomes clear. Even if every dollar of current tracked climate finance were directed to urban areas, it would still not be enough to close the infrastructure investment gap alone — indeed, it represents a small part of total financing flows — but it plays a vital catalytic role, and it will need to be scaled in the coming years.

46. Given the right financing conditions, cities can lead the global community in implementing low-emission, climate-resilient projects and setting in motion a transformation of society. Climate solutions should not merely include cities, but be born in and tested in them, capitalizing on their compact, connected, and climate-smart attributes. These solutions can come to fruition only if cities are able to finance and build low-emission, climate-resilient infrastructure, and to do so rapidly. Today's capital markets do not provide cities with adequate access to affordable financing suited to low-emission, climate-resilient infrastructure. The challenge is not simply to increase the amount of money in the pipeline, but also to create an enabling environment that encourages existing and new capital to flow from a broad spectrum of sources. Public and private funding can play a critical role in attracting investment. However, ramping up new channels of city finance — such as transfers from national Governments, revenues from local taxation and public services, borrowing from local financial institutions, development banks, and international public or private sources — will be essential to ensuring adequate project funding. Six major barriers that must be overcome are evident as areas to be addressed via policy: (a) uncertainty over regulatory and tax policies that affect low-emission, climate-resilient infrastructure; (b) difficulty in incorporating climate goals into urban infrastructure planning; (c) lack of city expertise in developing low-emission, climate-resilient infrastructure projects that can attract financing; (d) insufficient city control over infrastructure planning and complex stakeholder coordination; (e) high transaction costs; and (f) a lack of proven funding models at the city level.

Public-private partnerships

47. Public-private partnerships (P3s) have been gaining popularity in the developing world, particularly for expensive public infrastructure projects. However, P3s should not be considered a panacea, nor are they a substitute for establishing more fundamental, but underdeveloped, public finance mechanisms that

may be more appropriate for many public projects. If done properly, P3 projects can provide public services and benefits to local populations when government provision of the services is fiscally constrained. Some P3s can even achieve better economic efficiency than government-provided services. However, the results of municipal/urban P3s are mostly negative, presenting a number of challenges that can and should be addressed in policy.

48. Many governments take the approach of encouraging private sector participation through P3s. They choose this approach rather than financing the project themselves and contracting with the private sector to perform specific tasks. However, P3s are not a viable option for sidestepping the complexity and challenges of providing access to lower-cost municipal finance markets. It is important to note that P3s are appropriate only for a relatively small subset of public projects and can be viewed as a form of borrowing. Because the returns expected by private investors can be substantially higher than the costs of municipal borrowing, P3 projects need well-defined, self-generated revenues that are available to support these returns. In addition, in many parts of the developing world, P3s have limited application because poor policy and business environments make the public infrastructure projects that would be supported through P3s "unbankable" (e.g., lack of toll policy for the highway sector to capture revenues). Recently, the largest share of P3 investment in infrastructure has gone into telecommunications, followed by energy. Together, these two sectors accounted for almost four-fifths of total P3 investments from 1990 to 2008. Less than one fifth went to transportation and only about 5 per cent into water and sanitation (Bahl and Linn, 2014).[19]

49. In the realm of P3s, the key policy challenge that must be addressed involves creating an enabling framework where projects can succeed, as most project failures result from the inability of the government to manage P3s properly from conception to implementation. It is not uncommon, for example, that cities most in need of additional public infrastructure capacity are those least able to negotiate successful P3s. Governments without the legal and policy frameworks to enable access to debt markets usually do not have adequate legal and policy frameworks or the institutional capacity to effectively manage and execute P3s. Some P3 failures are attributable to local governments failing to honour the terms of P3 contracts, an enforcement challenge related to the rules of the game.

III. Prioritizing policy options: transformative actions for the New Urban Agenda

50. While it is impossible to summarize every type of law and policy that can advance fiscal health, the prevailing building blocks that can engender and advance strong fiscal systems are present when local governments have autonomy to set priorities for fiscal policy, particularly in the realm of revenues and expenditures. Also critical is a strong national Government that advances policy objectives that enable appropriate expenditure and functional mandates of municipalities, and empowers municipalities to: (a) establish and collect user charges and fees to cover expenditure costs; (b) share project execution, in addition to financing costs and

[19] One of the reasons for this distinction was the fact that there is a difference, according to the authors, in the ability to collect commercially viable user charges in the former two sectors as compared with the latter two.

responsibilities, via arrangements with private and public sector stakeholders; (c) expand local revenues through changes in property or sales taxes; (d) receive intergovernmental transfers from taxes collected by the central government; (e) use fiscal tools like municipal borrowing and land value capture to raise funds to support economic development and infrastructure; and (f) marshal resources to support credit guarantees or other credit enhancements to facilitate favourable borrowing (World Bank Group, 2001: 1). Operating from this premise, this section of the paper begins by discussing these policy priorities in the following areas that comprise municipal fiscal systems: expenditures; revenues; financial management; borrowing; and public private partnerships. Select examples are included illustrating how certain policy priorities in each realm can advance the New Urban Agenda via abbreviated case studies, and in exhibits 1 and 2 of the annex.

Expenditures

51. A priority for increasing the efficiency of local government spending is to hold local government officials accountable for the provision of quality public services while operating within a fixed budget constraint. A precondition for holding local officials accountable is the establishment of a financial accounting system that allows for the auditing of local budgets and financial transactions. Efficiency requires transparency, and transparency necessitates the availability of good data on revenue by source and on spending by functional category. Monitoring the provision of services is another priority — a task more difficult to do than the collection of financial data. Municipal governments should be required to inform their citizens and the national and state/provincial governments about changes in the crime rate, the educational achievement of students, whether streets are clean, whether all households have access to potable water, and other services.

52. National and state/provincial governments need to prioritize the important role they play in ensuring that municipalities can fulfil their responsibility to provide residents with high-quality public services. First, higher level governments should provide local governments with sufficient access to resources, either directly through intergovernmental transfers or indirectly by authorizing revenue instruments, so that local governments have sufficient revenues to provide the services. Second, higher level governments can strengthen incentives of local officials to improve expenditure efficiency through well-designed performance-based grants. Third, both national and state/provincial governments should provide incentives to improve local government expenditure efficiency through cooperative agreements to consolidate delivery of services, to share infrastructure, and, if possible, to facilitate new metropolitan-area intergovernmental collaboration.

53. Local governments need to improve long-term expenditure efficiency and improve economic performance by intentionally connecting the work of spatial and economic development planners and public finance offices so that plans and activities are coordinated in the long run. An important component of this coordination involves capital expenditures. Local governments need careful long-term planning to close yawning infrastructure funding gaps. Local governments also need to examine procurement practices to ensure that they are not exacerbating inequality and social exclusion.

Revenues

Fiscal transfers

54. The cost of allowing a fiscal transfer system to deteriorate, or not consolidating it sufficiently, is great, particularly as cities come under increasing fiscal stress as a result of ongoing urbanization. While every country will require its own set of measures to address its particular challenges, priority areas for policy action in this realm that can advance the New Urban Agenda are the following. First, policy must prioritize funding volumes for municipalities that are adequate. Aggregate transfers should be sufficient to cover or narrow fiscal gaps. It is important to take full account of increases in the scope of the responsibilities of municipalities as a result of factors such as demographic growth or additional functional mandates.

55. Second, improved grant design must be prioritized. In many countries, grants are allocated to municipalities on an ad hoc, non-transparent basis or replicate previously established patterns of resource distribution that are both inefficient and inequitable. This challenge can be addressed if transfers are allocated on the basis of clear and transparent formulas that reflect an underlying policy objective and provide for grant predictability so that local governments can budget effectively. In addition, an appropriate balance needs to be struck between grants that allow for the exercise of local discretion and those targeted at national policy objectives. While there is certainly a role for the latter, other things being equal, the overall structure of the grant system and the design of specific grants should underpin and expand the exercise of local expenditure autonomy. The principle should be that local governments should be allowed to determine expenditures in line with local needs in order to promote enhanced accountability and expenditure efficiency. In some cases, analysis reveals significant inequities in the horizontal distribution of fiscal transfers across municipalities; here, grant design should be strengthened to ensure greater equity in the distribution of grants.[20] Grant design should also be scrutinized for practicality and tested for feasibility.

56. Third, policy should limit grant proliferation. It is not uncommon for countries in which the intergovernmental system is evolving to experience periods in which municipal grants proliferate rapidly. In Uganda, for example, the number of fiscal transfers to local governments grew from 10 in 1997 to 46 in 2015. While driven by the best of policy intentions, situations like this can become unmanageable for the national agencies that administer grants and extremely burdensome for the local authorities that receive them and have to report on and comply with them. Donor programmes, driven by multiple objectives, can compound and aggravate the situation. The goals of grants from the central government should be aligned, and the number of grants should not expand to the point where the system as a whole becomes difficult to monitor and control, or where the municipalities receiving them are overwhelmed.

57. Fourth, policy should establish a framework for efficient transfer execution. The "plumbing" of the intergovernmental transfer system needs to function efficiently. In many countries, grants to municipalities are frequently delayed,

[20] In Uganda, for example, there is a large variation in the size of conditional transfers — the amount of per capita recurrent transfers received by districts and municipalities varied from less than Ush20,000 to more than USh300,000 in 2013-2014.

sometimes very significantly, engendering cash flow problems and difficulties in expenditure planning. A lack of predictability regarding how much will be allocated and when the funds will be accessible can be a major impediment to effective budget execution and investment programming. Thus, the basic operational systems and human resource capacities on which any fiscal transfer system rests need to be strengthened so that grants function effectively for their municipal beneficiaries.

Own-source revenues

58. Own-source revenues are essential for encouraging government efficiency and accountability. When local residents are paying for local services, they have a strong incentive to hold local officials accountable and encourage efficient service provision. Appropriate devolution of the authority to collect local taxes, to set rates, and to control assessments of tax bases can significantly improve overall effectiveness of local fiscal systems and should be a priority for policy-making. Local governments need to know how to identify their tax base, to estimate the value of the tax base, and to develop strategies to expand and improve it. Municipalities also need to monitor their own assessment records. In Latin America, for example, the majority of cities that disclosed their valuation records for comparison found their assessed levels were low (De Cesare, 2012).

59. An appropriate portfolio of revenue sources needs to be developed based on the characteristics of the tax base on which the revenue is generated and the quality of the revenue source. The quality of a revenue source relates to such issues as ease of collection and enforcement, horizontal and vertical equity, whether the revenue source distorts incentives or motivates bad behaviours, and whether the revenue source is stable, reliable, and predictable over time. The right mix of revenue sources can generate budget stability over time by matching more volatile sources like consumption or income taxes with less volatile revenues like the property tax or user fees. User charges are generally efficient and politically expedient instruments for local taxation of services like water, sanitation, and utilities; or for regulatory functions, like permitting and property registration, where beneficiaries and costs are easily identifiable. Charging beneficiaries directly for the cost of a service promotes efficient use of the service and is administratively simple to manage.

60. As most locally provided services directly benefit the local area and are capitalized into local property values, the property tax is a strong own-source revenue option, presenting another area of policy-making that should be prioritized. Although an effective property tax system requires good local capacity, it's potential to match tax burdens appropriately with expenditure benefits, to cause relatively little unwanted interference with market decisions, and to avoid imposing heavy burdens on poor families make it the most desirable of local taxes (Bahl and Linn 2014). Remedying perceived problems with the property tax may make it more acceptable to the citizenry on both political and policy levels. Possible remedies include strengthening the linkage between the payment of taxes and local improvements, allowing for greater local government control over the tax and its proceeds, easing administrative difficulties within the system, and ensuring fair

valuations, exemptions, and accountability (Ahmad et al., 2014: 22-28).[21] The property tax may be progressive in developing or transitioning countries, where the wealthy may not be paying income tax but hold large amounts of land and where those in public housing or low-valued properties are taxed at low levels or not at all (Bahl and Martinez-Vazquez, 2008: 3-4).

61. Value capture tools present another element that should be prioritized in policy in order to enable local officials to mobilize for public benefit all or part of the increases in land value that result from community investments rather than the actions of landowners. A long trajectory of international experiences has demonstrated that defraying at least part of the costs of urbanization by recovering part of the land value increments created in the process is feasible and practical.[22] Depending on the extent that national, regional, and municipal legal frameworks identify land value as a legitimate source of revenue, municipalities can mobilize a host of land-based revenues to meet expenditures and direct spatial growth.[23] The core concept that legitimizes the majority of land-based finance tools is land value capture, a concept that seeks to appropriate for public benefit all or part of the increments in land value resulting from public, rather than private, investments and actions.

Financial management

62. Municipal financial management reform must strengthen the foundation of financial management and focus on providing government officials with core basics before moving on to adopting sophisticated financial management tools. Policy priorities that advance stronger local financial management can be grouped into four broad areas: strengthening systems and processes; improving transparency and accountability; enhancing monitoring and oversight; and capacity-building. All of these areas are linked, and, as such, it is critical that reforms happen in a coordinated and sequenced manner, guided by actions and recommendations such as the following.

63. First, planning and budgeting frameworks and practices must be strengthened. Municipalities need to put in place policies, systems, and practices for planning and budgeting that go beyond the current fiscal year. Medium-term planning and

[21] A tax on real property (both land and buildings) carries certain advantages for subnational governments, including producing significant and stable revenue; being efficient and fair (although these positive characteristics are often undermined by excessive exemptions and preferential assessments for special interests (Bahl and Martinez-Vazquez, 2008: 3-4; Ahmad et al, 2014: 23); and being a visible tax, with taxpayers receiving bills and thus being made aware of the cost of public goods and services (Oates, 2001).

[22] Hagman and Misczynski 1978; Smolka and Furtado 2001; Vejarano 2007; Peterson 2009; Muñoz Gielen 2010; Alterman 2012; Ingram and Hong 2012; Walters 2012; Furtado and Acosta 2013.

[23] At the broadest level, global experiences with value capture tools point to the need to have value capture principles embedded in legal and planning frameworks, as well as bureaucratic practices and capacity-building initiatives.

budgeting will enable municipalities to adopt more realistic and efficient resource management especially regarding capital investments.[24]

64. Second, internal controls and cash management must be strengthened. Robust internal controls enable those in management roles to exercise their fiduciary responsibilities effectively. This maximizes the degree to which resources are spent in accordance with established rules and procedures. In view of the timing difference between revenue accruals and expenditure obligations, cash management is a critical area for attention. Efficient cash flow forecasting and planning enables municipalities to manage their short-term financial obligations in a cost-effective manner.

65. Third, asset management and maintenance must be strengthened. Municipal officials often focus on new capital investment projects at the expense of sound asset management and maintenance. Maintaining asset inventories, adopting modern asset valuation practices, and deploying modern financial management tools, such sinking funds, enable municipalities to manage their assets and budget for asset replacement efficiently. This requires maintenance of up-to-date records of assets, and budgeting for operations and maintenance should be reflective of the effective life span of assets.

66. Fourth, promoting uniform standards and practices for accounting and reporting is important. Adopting standards for municipal accounting and financial reporting that are in line with international public sector accounting standards must be a key priority. While advanced countries have separate accounting standards and standard setters for subnational governments, most developing countries do not. International Public Sector Accounting Standards (IPSAS) provides a useful model for developing countries to adopt, but countries need to customize IPSAS standards to suit the requirements of their own municipalities and to lay out a structured path for the gradual adoption of international standards over time. Municipal governments should commit to preparing and publishing financial reports on a regular and timely manner to enhance transparency and financial accountability to their stakeholders.

67. Fifth, enhancing the use of information systems must be prioritized. Use of modern information technology systems for managing the core components of municipal financial management is prerequisite for efficient municipal operations. Care should be taken to ensure that systems design and functionalities match the requirements and capacities of municipalities. Digitizing tax records and computerizing accounting and asset management functions are typical starting steps with the adoption of management information technology systems.

68. Sixth, improved monitoring of municipal financial performance is critical. Higher levels of government need to invest in creating sound monitoring arrangements at the municipal level to meet the needs of both management and stakeholders outside the municipality.[25] Local governments need to track key

[24] Longer-term planning requires predictable revenues (often through intergovernmental transfers) as well as sound capital budgeting skills. Budgeting should be comprehensive so that it includes not only core municipal functions but also devolved responsibilities and agency functions. Crucially, efficiency in budget execution requires investment in capacities and skills in planning, procurement, and contract management.

[25] Outside stakeholders include higher levels of government, municipal associations, and financing institutions.

financial metrics (e.g., liquidity, collection efficiency of own-source revenues, efficiency of budget execution, and follow-up on audit observations). Monitoring of municipal financial performance by external stakeholders permits comparisons of municipal performance and can flag when technical assistance and capacity support may be needed in weaker municipalities. Regular monitoring also provides early warning to higher government levels of potential fiscal risks at the subnational level and helps them to discharge their fiduciary responsibilities regarding intergovernmental transfers. Defining suitable performance metrics and setting up online databases for storing and sharing municipal financial data are additional key steps to be taken by higher levels of government.

69. Seventh, municipal audit systems and practices must be strengthened. Setting audit standards for municipalities in line with international public sector audit standards is essential, as is reinforcing a culture of regular and timely audits. Higher levels of governments need to monitor local governments for timely and robust follow-up on audit recommendations. Sharing of audit reports with citizens and stakeholders enhances the transparency and accountability of municipalities and strengthens citizen engagement in local governance. Bangladesh is an example of a country that has tackled the municipal audit challenge with some success, as further described in this paper.

70. Eighth, participatory planning and budgeting should be enabled. Because local governments are closest to citizens, municipalities have a responsibility to engage actively with their stakeholders. Their plans and programmes need to reflect citizen priorities, and citizens need to be made aware of how well the municipality is meeting its mandated responsibilities. Enabling citizens to participate in the planning and budgeting process of the municipality is a good way to ensure that municipal plans and budgets reflect citizen priorities. Promoting access to information must be a priority. Sharing budgets, financial reports, and audits with the community provides citizens and stakeholders with first-hand information on the efficiency and effectiveness of municipal management. Uploading procurement and contract management information in a public space such as the municipal website strengthens the transparency of local government management. Legal enactments of "right to information" and "open data" initiatives in many countries have strengthened citizen participation and involvement in municipal management and enhanced the accountability of local governments to citizens. Citizen participation is becoming a part of local government systems in various parts of the world, as further described in the materials in exhibit 2 of the annex.

71. Finally, systematic capacity-building, and peer learning, must support all of the noted priority areas. Both central and local governments need to be able to assess the status of institutional systems and have a baseline from which reform efforts can be calibrated. The Public Expenditure and Financial Accountability (PEFA) tool for subnational governments offers a good starting point that reformers can use to set priorities for reform and capacity-building efforts. The PEFA framework provides a set of practical indicators to measure performance, establish baselines, design reform and capacity-building programmes, and measure the progress of reforms. The municipal PEFA programme in Tunisia is currently using the PEFA framework to assess the institutional systems and capacities of seven large and medium municipalities to design an integrated reform and technical assistance programme to strengthen municipal financial management.

72. Financial management reform and capacity-building require hands-on technical training more so than conceptual instruction in a classroom across all the noted areas. Experience of the World Bank in several countries has shown that a "learning by doing" approach, where capacity support and technical assistance are provided directly into the day-to-day operational context of municipal governments, is much more effective than classroom training divorced from the work situation. Similarly, peer-learning networks, where local governments and their staff share and learn from the experiences of others, have been shown to be potent ways to build and sustain staff capacities.[26]

Borrowing

73. Priorities for policy and institutional action will be very different, depending on where a country falls on the spectrum of capacity. While countries at difference segments of the spectrum will require their own set of policy priorities to enable strong frameworks for borrowing, a few key areas we can identify that have global relevance are the following.

74. In mature municipal debt market countries, where basic systems are in place and functioning relatively effectively, there are two core policy priorities. The first is to develop more efficient systems of debt issuance. Thus, in Western Europe various initiatives are underway to develop and/or expand the activities of local government funding agencies, which allow municipalities to pool their bond financing needs and gain access to capital markets to supplement more retail-level bank lending systems. The second is to develop regulations and systems to better manage the risks related to municipal borrowing, such as municipal bankruptcies.

75. In undeveloped debt market countries, the four factors that determine municipal borrowing are generally all so weak that, in the short- to medium-term, municipal borrowing is unlikely to emerge to any significant degree and is arguably not a policy priority. The focus needs rather to be on the basic elements of well-functioning city governments: stabilizing municipal systems; rationalizing municipal expenditure assignments and buttressing revenue flows; improving municipal budgeting, planning, and project-execution powers; and deepening the financial sector. Once these elements are in place, steps to develop a municipal debt market could then commence. Premature attempts to stimulate borrowing without these fundamentals run the risk of doing more harm than good, as in the case of collapsed municipal development funds in Malawi, the United Republic of Tanzania and Kenya.

76. *Developing municipal debt market countries display a wide mix of circumstances*. Broadly, they are all characterized by having some basic strengths and capacities in the four factors described earlier. They have cities that are growing steadily richer, but are not yet able to borrow at the levels characteristic of developed market countries. For this class of countries, policy and institutional

[26] In India, the Karnataka Municipal Reform Programme financed by the World Bank created an internet-based group for sharing information among municipal financial officers. Supported by a small technical team at the Municipal Reforms Cell in Bengaluru, the group was able to come up with a variety of practical and innovative solutions to municipal financial management issues. The Public Expenditure Management Peer Assisted Learning (PEMPAL) network in Europe and Central Asia is another good model that could possibly be replicated in the area of municipal financial management.

action on the municipal borrowing agenda should be a priority. Within the class, two groups of countries can be distinguished: those (such as South Africa and Hungary) that have solved the basic systemic challenges and thus are a bit closer to the developed-market side of the spectrum, where both primary and secondary market activity is still limited and immature; and those (such as Viet Nam and Indonesia) where significant systemic challenges have yet to be effectively addressed. The South Africa case presents perhaps the clearest demonstration of how concerted action to address the fundamental constraints on municipal borrowing can yield tangible and sustainable impact, as shown in the materials in exhibit 11 of the annex.

Public-private partnerships

77. P3s are an important component of a complete portfolio of mechanisms available to support public projects. Even in the absence of a complete portfolio, P3s can sometimes offer an alternative for financing important projects in underdeveloped finance systems. Accordingly, strengthening legal and regulatory frameworks is integral to the success of a P3 and key areas of policy priority (and action) are as follows.

78. Policies should provide clear guidelines and/or technical assistance for municipalities to help local officials assess whether activities to be funded through a P3 are appropriate for the funding structure and to ensure that terms are negotiated in ways that align with project goals and outcomes. Local governments with a weak judiciary may want to consider adopting arbitration frameworks as one step toward building the foundation P3s need to succeed, absent a robust judiciary. An important priority is the formulation of sectoral strategies and plans (transport, housing, etc.) that clarify the governmental and institutional arrangements and procedures for P3s. It can be helpful to develop some permanent advisory capacity, such as centralized national P3 units, to support municipalities pursuing P3s that helps local governments obtain guidance to ensure that P3s are fit for a planned project.

79. Additionally, P3s often tackle issues (e.g., transportation, water, sewer, etc.) that span more than one municipal boundary. Accordingly, regional collaboration is an important element to be considered for these models to be optimized. It can be helpful to consider ways to improve the bankability of public infrastructure projects by reforming sector policies and public finance frameworks (e.g., adopting the "users pay" principle) as a policy priority.

IV. Key actors for action: enabling institutions

80. In countries across the world, responsibility for expenditures, revenues, borrowing, and the delivery of public goods and services falls upon key actors and institutions at all levels of government, from national or state/provincial governments to the local level. Municipalities also rely on important private and non-profit sector actors to conduct business. As will be discussed in the following section, the successful implementation of the New Urban Agenda requires understanding, first, the basic systems and frameworks of governance within which government actors and institutions operate. Second, strategies and examples for how these various actors and institutions can work together with members of the private

and non-profit sectors to best advance municipal fiscal systems in these various frameworks for governance are discussed.

81. Understanding key actors in global fiscal governance begins with distinguishing the three major systems of governance in the developed and developing world where all actions occur: federal systems, unitary systems, and confederate systems. In federal systems, two levels of government share ruling authority, each reserving certain powers over areas of action and each possessing an inherent guarantee of power and autonomy for governance within these areas. Examples of federal governments are Mexico, United States and Australia (Riker, 1964: 11). In unitary systems, constitutional authority is vested in one sovereign national Government, and any decision-making power vested in subnational governments is delegated from the national Government (Norris, 2008: 9). South Africa, the United Kingdom of Great Britain and Northern Ireland, France and China provide models of unitary systems.[27] In confederate systems, independent States delegate power to a central national Government for specific purposes; the balance of authority resides with the confederate states.

82. The three categories of governance structures can be subdivided by myriad features, including, most notably, varying degrees of devolution. Devolution is the selective decentralization of authority and transfer of responsibility for public functions from the central government to subordinate or quasi-independent government organizations (Norris, 2008: 10).[28] Fiscal decentralization governs the degree of autonomy and flexibility actors in local government have to implement

[27] This paper presents a basic typology, but wide variability within the different types of frameworks is highly relevant to governance. For example, the Republic of South Africa is governed by a three-tier system of government and an independent judiciary. South Africa operates as a parliamentary system, with legislative authority held by the Parliament of South Africa and executive authority vested in the President of South Africa, who is elected to a fixed term, and his Cabinet. In South Africa the national, provincial, and local levels of government all have legislative and executive authority in their own spheres. To learn more about the South African constitution and framework for fiscal governance, see Blochliger and Kantorowicz.

[28] Accordingly, decentralization is multifaceted and informs how fiscal, administrative, and political functions are shared across various levels of national, provincial, and local government (Pippa 10). The concept is fluid — often evolving and changing over time as a result of ongoing negotiated compromises among advocates who place different values on local autonomy, reflecting the changing tenor of politics, technical efficiency, and other factors (Bahl and Linn, 2014: 15). Devolution and decentralization can be symmetrical, with all subnational units having the same powers and status, or asymmetrical, with regions varying in their powers and status (Bahl and Linn, 2014: 15). In federal or unitary systems, for example, a greater degree of self-rule can be given to sub-central units or self-identified communities — as opposed to an integrated model where decentralization and devolution are asymmetrical (Bahl and Linn, 2014: 15). For example, in São Paulo, Brazil, services are delivered by 39 autonomous municipalities, while in Mexico City, two states, a federal district, and over 50 local-level governments have a stake in governance (Bahl and Linn, 2014: 12). Johannesburg and Cape Town present examples at the opposite end of the spectrum, where metropolitan governments deliver assigned services on an area-wide basis with little autonomy at the sub-metropolitan level (Bahl and Linn, 2014: 12).

change within all three systems of governance (federal, unitary or confederate).[29] When local governments are tasked with new expenditure requirements, there must be a concomitant devolution of financial resources to support the expenditures, along with strong national Government support of these principles (in policy and practice) that empower key actors in leadership roles to make decisions with true autonomy (Ezeabasili and Herbert, 2013: 2).[30]

83. Because the complexity and variability across countries in the developed and developing world is so broad and diverse, it would be practically impossible to list all of the key actors and institutions within them that are relevant to sound fiscal health. Accordingly, the focus of this section now turns to providing strategies and recommendations via illustrative examples of how key actors and institutions are working together (within government and with private sector and non-profit/non-governmental actors) to advance municipal fiscal systems.

84. *Cooperation by key actors to achieve regional coordination in planning and public finance functions*. Coordination among multiple levels of government in planning and public finance is critically important for sound municipal fiscal systems, and examples of how key actors play a role to address this are illustrated in the history of São Paulo, Brazil. The São Paulo metropolitan region is governed by 39 municipalities that, historically, have faced a host of economic and fiscal challenges, including a declining industrial base, disparities among municipalities in access to services and revenue capacity, and significant indebtedness at the local level (Bahl and Linn, 2014: 14). The horizontal fragmentation of the metropolitan government structure, coupled with weaknesses in municipal administration, made it challenging to address these problems. Neither national nor state-level authorities were empowered to force municipalities to cooperate (Bahl and Linn, 2014: 14). Over the years, a number of ad hoc solutions were implemented, including the formation of discretionary metro-wide development councils and various "consortia" for planning and coordination around specific functions (for example, port management). None offered lasting ways to resolve the coordination deficit (Bahl and Linn, 2014: 14).

[29] Many different types of decentralization with different characteristics exist across the developed and developing world, and it is important to distinguish them. The various types of decentralization include but are not limited to (a) political decentralization; (b) administrative decentralization; (c) economic or market decentralization; and (d) fiscal decentralization (*The Online Sourcebook on Decentralization and Local Development*). This paper focuses on examining best practices related to fiscal decentralization only, in alignment with the thematic focus of the paper.

[30] Several examples exist where the fiscal autonomy of local governments is enshrined in a constitution in meaningful ways. For example the French Constitution stipulates that "whenever powers are transferred between central Government and the territorial communities, revenue equivalent to that given over to the exercise of those powers shall also be transferred." (Title XII, On Territorial Communities, article 72-2). A similar example is present in the Constitution of Greece, which states, that "[E]very transfer of competences from central or regional administrations of the State to local government also entails the transfer of the corresponding funds" (Section VI, Administration, article 102-5). The European Charter of Local Self-Government (1985) contains several articles related to the financial autonomy of local governments and many countries which have ratified it have taken legal steps to comply with these articles. When renewing local government laws in 2004 and 2005, Turkey, for example, made an important effort to harmonize its laws with the Charter.

85. Lack of coordination, coupled with horizontal and vertical governance problems, contributed to weak municipal investment, insufficient planning, infrastructure shortcomings, and the underutilization of funding instruments such as bonds and the sale of development rights (Bahl and Linn, 2014: 14). To address this, a meaningful effort at improving metropolitan governance was undertaken in 2011. Under state law, a new set of metropolitan planning and coordination mechanisms was created (Bahl and Linn, 2014: 14). The law established several new institutions and key actors: a metropolitan development council for planning and land use, transport, housing, sanitation, and the environment, with representation from state and municipal authorities; a consultative council of key metropolitan stakeholder groups; a regional enterprise for investing in and financing selected metro-wide functions (transport, housing and sanitation, and environment); and a regional development fund that supports municipalities with finance and technical assistance (Bahl and Linn, 2014: 14). Whether and how this new set of institutional mechanisms will overcome the longstanding metropolitan governance challenges in São Paulo remains to be seen, but the effort illustrates how law and policy can establish a framework for advancing regional cooperation between key actors in government and the private sector to achieve greater coordination in planning and public finance.

86. In another illustrative example, Bahrain made it mandatory for all entities, private and public, to apply for building permits before commencing any project. Upon submission, the application is circulated to all public infrastructure stakeholders and their feedback is requested — incentivizing collaboration between key actors and institutions that play important roles bringing new projects and financings to fruition. The process allows each key actor in municipal capital planning and budgeting to assess each project individually and confirm whether it is consistent with the national Government's development plans for their specific field. Each key actor's response is available to all other public infrastructure stakeholders via the same platform, providing a communication mechanism that engenders cooperation between the local government and the national infrastructure providers with respect to implementation and finance of infrastructure in ways that increase the likelihood of success of new projects. The system also provides a meaningful integration point for the government and private sector actors that play a pivotal role in capital finance decisions.

87. *Coordination by key actors to achieve budgetary transparency*. Through leadership of the Vietnamese Ministry of Finance, and a supporting role of the United States Treasury, changes were made to implement the use of International Public Sector Accounting Standards (IPSAS) by Viet Nam's public sector entities. Developed for use by public sector entities around the world, these standards improved the transparency, quality, and comparability of Viet Nam's municipal data and other public data (United States Treasury, 2014: 3). As part of this effort, Viet Nam developed a new "chart of accounts" to bring the government's financial management framework into compliance with international standards, drafted changes to national laws and regulations to harmonize these with the IPSAS, and supported the development of a standardized financial reporting template to be used by all spending units within the government (United States Treasury, 2014: 3). Viet Nam has seen tangible improvements in the market perceptions of its risk profile, underscoring the importance of quality data to municipal credit analysis when governments access the capital markets for funding. These efforts enhanced the

relationship among government and key private sector actors, as enhanced data is important to underwriting, capital markets, and credit stakeholders that provide important fiscal liquidity to municipalities. In other settings, budgetary transparency includes a range of actors that can advance efforts to reduce inequality or promote gender equity via participatory budgeting practices. Examples of this are presented in the notes and exhibit 2 of the annex to this paper.[31]

88. *Coordination by key actors to fill capacity gaps*. The presence of an effective, strong, and implementable law and policy framework is not sufficient to promote municipal fiscal health. The capacity of local government officials to achieve coordinated governance and execute around policy, law, and constitutional mandates is necessary, and at times difficult to achieve (Bahl and Linn, 2014). This is particularly challenging in resource-constrained settings, and in those instances non-governmental actors can play a very important role. (United Nations Development Programme, 2015). Bangladesh offers an illustrative example. There, capacity-building partnerships where built among actors charged with audit functions in government and private sector experts to ensure that local officials could comply with a constitutional mandate that established an audit requirement in connection with the administration of a system of block grants for 4,500 rural local governments (Farvacque-Vitkovic and Kopanyi, 2014). Additional examples of the important role key actors play when they work together to advance municipal fiscal systems in the areas of revenues, expenditures, borrowing, public private partnerships, and climate finance appear in other sections of this paper and in exhibit 3 of the annex.

V. Policy design, implementation and monitoring

89. Changes to policy that enable the implementation and monitoring of new practices in governance or municipal fiscal systems are often adopted via amendments to the "rules of the game" — the existing laws, constitutional amendments, new legislation, or changes in the common law of a jurisdiction. That process is often most successful when public officials have a clear understanding of the strategic priorities that should be enshrined in law. That understanding can be enhanced by awareness of legislative frameworks that are working for their peers in

[31] Examples of participatory budgeting with an eye towards gender and equity are seen in the efforts undertaken by Villa El Salvador, a district within the city of Lima, Peru, known for its tradition of popular participation in the regional process of decision making. The civil society of this municipality has been engaging in a reform programme that had the aim of recreating democratic institutions through increased citizen participation through national government legislation. As brief background, Peruvian Law requires the existence of regional and local coordinating councils which are allowed to further specify the national participatory budgeting rules, with the goal of achieving better representation of the local population (i.e., they could create laws which take gender, indigenous or marginalized groups, or other factors into account). To learn more about this example of how national Governments can create a framework where local rules are determined, in effect, with an element of citizen-government deliberation that can include gender and equality based considerations, visit this link: http://participedia.net/en/cases/participatory-budgeting-villa-el-salvador-peru. Participatory budgeting is also widely adopted in the United States to integrate the voices of various types of constituencies to the budget process. To learn more about how the city of Boston is implementing participatory budgeting to give the city's youth a voice in the city's budget, please visit this link: http://citiscope.org/story/2015/how-boston-gives-youth-control-over-part-city-budget.

government on a global scale as a guiding consideration for policy design. To that end, key strategies for policy design, implementation, and monitoring are identified below in areas that are critical to fiscal health: expenditures, revenues, borrowing, financial management, climate finance, and public private partnerships. Because the needs of municipalities are broad and diverse on a global scale, a policy matrix is also included in exhibit 2 of the annex to this paper that presents examples of legislation in various jurisdictions in different countries that serve as best practices in policy design, implementation, and monitoring to advance municipal fiscal health when present in a constitution, or in stand-alone legislation.[32]

Expenditures

90. To ensure that local governments have the resources and steward them effectively to discharge new expenditure responsibilities effectively, the following principles provide guidance for policy design, implementation, and monitoring.

91. First, national and state/provincial governments must expand intergovernmental transfers to municipalities. These new allocations should account for the extra expenditures associated with devolved expenditure responsibilities and the ability of local governments to raise revenues given the mix of revenue sources they have at their disposal. In addition, sound implementation of expenditure authority also requires strengthening local government accountability to residents. The fact that a municipal government has adequate resources to finance a wide range of local public services is not a guarantee that an acceptable level of public services is actually being provided. There are many examples of local governments that perform poorly — although money is being spent, service levels can be low, highly unequal, or non-existent. The roots of such operational inefficiency must be addressed. Local government inefficiencies may be due to poorly trained public managers, to dysfunctional management and accounting systems, or to fraud and corruption. Public employees, especially if they are poorly compensated and inadequately managed, may accept bribes, be frequently absent from work, or steal money from the public coffers. An anti-corruption regulatory framework can address these problems, as can capacity-building efforts to make local governments more accountable to their residents.

92. While transparency and accountability can go a long way toward keeping procurement from worsening inequalities, better procurement rules and practices provide an important mechanism for more affirmative efforts to address historic legacies of exclusion based on race, gender, or ethnicity, and corruption. More proactive procurement rules could include special provisions for contracting with businesses run by women or other disadvantaged groups. They might also include efforts to influence the business practices of government contractors through requirements that contractors honour such things as gender-based wage equity or equal employment opportunity practices.

93. Closing the infrastructure financing and funding gaps will require action from all levels of government. In developing countries and many developed countries, national Governments will need to significantly increase intergovernmental transfers to provide necessary resources. In addition, national Governments will

[32] A broader survey of legislation relating to municipal fiscal health in developed and developing countries across the world is included in the policy matrix that appears in exhibit 2 of the annex to this paper, available at: https://goo.gl/Dw6grF.

need to enable local governments to raise new sources of revenues — for example, through land value capture instruments — to help finance new infrastructure investments. For their part, local governments will need to develop and maintain capital accounts in order to prioritize new capital expenditures and to keep attention on infrastructure maintenance needs. In addition, making capital accounting more public can introduce new levels of transparency and accountability that will focus public attention on these essential public goods.

94. Additionally, in many instances, local governments operate inefficiently because they fail to exploit economies of scale — a failure that stymies effective implementation of expenditure authority. Many local government public services, such as sewage, refuse collection, the provision of water, and transport systems can be produced at much lower cost if they are organized over an entire urbanized area. In a number of countries, including the United States, urban areas are frequently highly fragmented. The Chicago metropolitan area, for example, includes 382 independent general-purpose local governments plus hundreds of additional special-purpose governments. High degrees of fragmentation make coordinated infrastructure planning difficult. The result is wasteful duplication of public facilities, little joint planning for environmental disasters, and encouragement of urban sprawl. A model for addressing this issue in ways that support sound implementation can be found in France, which recently established the Métropole du Grand Paris (Greater Paris Metropolitan Authority), a new government body designed to play an important role in coordinating public investment across the Paris region. Other examples of the benefits that can be gained when national Governments encourage economies of scale via the alignment of infrastructure planning and financial planning are found in Bahrain's building permit system, as well as in Toronto, Johannesburg and Cape Town, and Shanghai.[33]

Revenues

95. To ensure that local governments have sufficient revenues to meet expenditure needs, the following principles are guiding considerations for policy design, implementation, and monitoring in the area fiscal transfers and own-source revenues.

Fiscal transfers

96. Like other aspects of municipal finance, municipal grant systems are highly country-specific, highly political, and legally constrained. In most countries, at least some elements of the fiscal transfer system are written into law, and in some countries, elements such as a minimum unconditional annual allocation of national revenues to local governments are embedded in the Constitution. Actions to strengthen municipal transfers, either as a whole system or in grant-specific part, thus require country-based approaches in which the broad areas for priority action identified above are tackled in appropriate ways. In developing implementation strategies to reform and strengthen transfer systems, a number of important points may be considered.

[33] As noted in the paper, recently, Bahrain has made it mandatory for all entities, private and public, to apply for building permits prior to commencing with any project. See exhibit 3 of the annex for an expanded description of this effort.

97. Various "good practice" approaches to grant design have been established in the public finance literature that now exists on fiscal transfers. They include principles such as transparency, predictability, and simplicity. In addition to these substantive principles, it is important that the grant design process include sufficient consultation with municipal beneficiaries of grants and associations representing the interests of these municipalities. Efforts to introduce new grants or restructure existing ones should be undertaken with due regard to the established principles and to the extensive international experience that has developed in this area.

98. Significant adjustments to the distribution of grant resources among jurisdictions tend to create winners and losers. This can engender crippling political opposition to reforms and, at the extreme, throw severely losing municipalities into fiscal shock. It is recommended that the losers, or biggest losers, to reforms be "held harmless" to some degree. A shift in allocations among municipalities might be accompanied by an overall increase in aggregate grant allocations so that negative impacts on the losers are mitigated. If, for example, the distribution of health transfer payments to municipalities' shifts from funding the costs of existing clinics to a simple population-based grant, the system will become more equitable, but municipalities with a disproportionately high number of clinics at the time of the shift will face grant losses. Compensating losers may have the useful impact of increasing the total allocation to the municipal sector, but, in a world of finite budget resources, it must also be affordable to the central or state/provincial government. The key point is that grant designs for reform efforts often need to address distributional impacts, at least in the short-term, in order to be effective.

99. An important set of innovations that has emerged over the past 15 to 20 years concerns grants that focus on strengthening the institutional and delivery performance of municipalities. Providing fiscal transfers and capacity-building inputs that combine objective allocation formulas based on population or poverty with criteria relating to performance in areas such as budgeting and financial management, planning and project execution, accountability, and service delivery can incentivize and support these objectives. These grants require a clear capacity-building programme in place to help local governments achieve targets and a transparent and independent oversight/monitoring process to review municipal performance and compliance. Performance grants have now been introduced in over 20 developing countries across Africa (Uganda, the United Republic of Tanzania and Ethiopia), South Asia (India, Bangladesh and Nepal) and East Asia (Indonesia). Municipal contracts based on mutually binding agreements between central and local governments are performance-based instruments that have fostered good intergovernmental partnerships. A number of countries in Europe have adopted the municipal contract approach.[34]

100. An emerging area potentially deserving of a new generation of intergovernmental grants is environmental and climate change infrastructure. The positive externalities of such investments — to surrounding jurisdictions, the country, and globally — provide a strong public finance rationale for such grants.

[34] In France, municipal contracts were introduced in the 1980s and by the 2000s, 247 municipal contracts involving 2,000 municipalities had been signed in support of inter-municipal investments valued at 2 billion euros. In Africa, municipal contracts have been used in countries such as Tunisia, Morocco, Senegal, Guinea, Mali and Mauritania.

They can be designed across a fairly wide spectrum of focus and sophistication in line with the specific objectives and constraints of the country.[35]

101. It is essential that municipalities be prepared to effectively monitor and report on the receipt and use of grant funding. This is particularly important for grant programmes intended to impact positively on the lives of citizens, particularly the poor or disadvantaged. Merely allocating and transferring funds to municipalities does not guarantee these impacts. Municipalities need to spend funds appropriately and in line with individual programme objectives, while national agencies need to continually monitor and engage with municipalities to address emerging problems and seek new ways to improve programme performance. The national Government should establish clear and transparent systems of reporting on the usage and the outcomes of grants. At the local level, monitoring and evaluation are important tools in strengthening the outcome and impacts of individual programmes.

Own-source revenues

102. National and subnational governments need to invest in both the technical and the human resources needed to maintain effective local tax systems. Low-cost cadastral and assessment innovations and digital systems for mass assessments can increase local capacity for effective assessment of the tax base.[36] Given the importance of accurate and even assessments, enforcing accurate value reporting is key. Adopting integrated reporting, assessment, and collection systems, using internet or mobile platforms to manage tax bill payment, and imposing penalties for tax evasion can strengthen tax systems and improve the ability of local governments to meet obligations.

103. Since user charges or property taxes generally cannot be levied at high enough rates to cover entirely the expenses of local governments, coordination of own-source revenue collection with an effective system of intergovernmental fiscal transfers is essential for developing local capacity to generate own-source revenues and for achieving sustainable fiscal health. In addition, other land-based revenue sources such as land value capture can be developed to supplement property taxes. Countries and jurisdictions that have been able to innovate and expand upon land-based financial tools for revenue generation tend to enshrine the notion of the social function of land within key constitutional documents and legal codes. The principle of the social function of land establishes land as an essential collective good that requires protection and can justify some curbs on private property rights. Helping to establish the separation of building rights from landownership rights is the principle at the core of key revenue-generating tools such as land value capture.

104. The implementation of land value capture tools involves a multipronged approach that includes educating policymakers on the legal and economic foundations of value capture, building capacity among local public officials to calculate and reclaim land value increments, and educating non-governmental stakeholders on the merits of sound land and urban development policies. Land

[35] It is noteworthy that the recently published "State of City Climate Finance Report 2015" of the City Climate Finance Alliance suggests this as one of its chief recommendations to deal with the city climate infrastructure finance challenge. Some countries (such as South Africa) have begun experimenting with grants of this type.

[36] For example, Chile, Honduras, and Nicaragua use modern geospatial cadastral systems (De Cesare, 2012).

value capture will more likely succeed when stakeholders understand that the practice promotes better performing land markets and reduces incentives for land speculation.

Financial management

105. Implementing municipal financial management reform is critically important to advance sound fiscal systems and that process is enhanced by the following strategies and considerations for policy design, implementation, and monitoring in financial management. First, institutional coordination should be strengthened. Municipal financial management reform and capacity-building should focus on getting the basic foundations for sound financial management established in municipalities and ensuring that the incentives, systems, and capacities for sustaining them are in place. The role of higher levels of government is critical and should be clearly defined at the start. Higher level governments should focus on setting the enabling policy and institutional framework, facilitating capacity-building, and setting up monitoring and oversight frameworks. Suitable institutional coordination frameworks should be put in place so that technical assistance and capacity-building provided by higher level governments and/or donors can support effectively the implementation and management of financial management systems and practices at the municipal level.

106. Second, incentives should be created for municipal financial management reform. Experience has shown that municipal financial management reforms usually have long gestation periods and cannot be achieved by quick-win or one-shot approaches. Achieving optimal results for municipal financial management reform requires a clearly laid out policy and process guidelines, an integrated approach to reforms, sustained capacity support, and technical assistance. Sustaining reforms and institutionalizing them also requires that incentives at the local government level are aligned with reform objectives. Experience in several countries has shown that a feasible way for higher level governments or donors to create these incentives is by incorporating them into the design of performance-based intergovernmental fiscal transfers systems.[37]

Borrowing

107. A number of elements can contribute to successful policy design, implementation, and monitoring of the priority areas that have been identified in the realm of borrowing. The main objective of action in this area should be to expand sustainable municipal debt markets in countries where fundamental conditions permit risk to be appropriately allocated and properly priced. Such efforts are most sensibly placed on developing municipal markets. Recent studies in these markets indicate that the primary challenges to increased private sector investment in municipal debt are not on the supply side: financial markets, even in countries such as Viet Nam, are often reasonably liquid, and there are substantial volumes of

[37] In countries such as the United Republic of Tanzania, Ethiopia and Sri Lanka, fiscal transfer programmes have been established that require local governments to comply with basic financial management requirements (such as having a participatory plan/budget, requiring an audit opinion on the municipality's financial statements by an independent external auditor, and publication of procurement plans in the municipal website) as a prerequisite for receiving fiscal transfers or for receiving financing support for investment projects from donors. These requirements can act as incentives to improve the quality and performance of municipal financial management.

finance seeking medium- and longer-term investment opportunities. The core problem is that, given deficiencies in certain factors identified earlier in this paper, many municipalities do not present themselves as feasibly underwritten borrowers.[38]

108. To bolster municipal borrowing, central governments tend to focus on supply-side interventions. Most often, this has involved the creation of government-capitalized and operated municipal financing intermediaries, or municipal development funds. Many such entities have been established over the past two decades; others are under construction, including in Viet Nam and Indonesia. Independent reviews of the experience of such entities have seldom been undertaken, but where they have reviews, the track record is decidedly mixed.[39] Central Governments have not been able to execute sound credit judgments nor have they enforced commercial credit practices on subnationals. Municipal development funds have often been plagued by chronic financing and sustainability difficulties, usually linked to large non-performing loan portfolios. Even where such problems have been escaped (FINDETER in Colombia and the Tamil Nadu Urban Development Fund are often used as positive examples), there may be problematic systemic impacts. For example, in benefiting from cheap or free State-provided capital, such entities pursue lending practices that tend to squeeze out private capital, rather than draw it into the sector.

109. While there may be a role for carefully crafted supply-side interventions focused on accelerating municipalities' direct access to capital markets, it is axiomatic that efforts to expand the flow of private credit into the municipal sector without creating moral hazard must deal with the core demand-side and regulatory constraints that impede these flows. Such efforts will require action at three levels: policy design that engenders reform; capacity-building; and institutional interventions. Both central and local governments will need to be involved, though with different roles and in differing ways.

110. Constraints to expanding municipal borrowing arise predominantly from four sources: a weak intergovernmental fiscal framework and limited or unpredictable municipal revenues; weak municipal financial management, including opaque accounting systems and poor financial data; shallow capital markets; and an underdeveloped regulatory framework for municipal borrowing. Most policy reform in this realm will be designed by national Governments, or, in some federal countries, by state/provincial governments. Improvements in the policy environment across the first three areas should be systematically pursued; they are important in

[38] The South Africa example offers reason for hope; it shows that serious efforts to deal directly with these constraints in a manner that does not create moral hazard can bear fruit. As weaknesses are addressed, the supply side responds with increased financial flows into the sector over time.

[39] A review of over 25 developing-country municipal development funds (MDFs) found the following: "Unfortunately, however, few developing-country MDFs have either evolved into market oriented suppliers of credit capable of mobilizing private sector savings, or have smoothed the way for private sector participation in the municipal credit market. Most have remained specialized and isolated channels for international donor or government funding. Parastatal institutions that draw only on public sector funds cannot finance the magnitude of urban investment needs that have been identified. Moreover, they run against the policy trend of liberalizing financial markets. In effect, they substitute government loans for government grants. This stretches the public sector budget, but leaves largely unchanged the process of mobilizing and allocating capital." (George Peterson, *Using Municipal Development Funds to Build Municipal Credit Markets*, 1996).

their own right and, in combination with other factors, they will enhance municipalities' access to credit. With respect to the fourth area, with some notable exceptions (e.g., South Africa and Hungary), most developing market countries have inadequate or poorly developed municipal borrowing regulatory frameworks.

111. Implementing meaningful advancements in this realm will require specific, concentrated policy efforts. Globally, three main approaches to the regulation and control of municipal borrowing can be identified that are important for policy design: (a) "market-based" systems provide for administrative oversight within a broad legal framework. Decisions about municipal borrowing are made by borrowers and lenders with some level of administrative oversight, but without transaction-specific, higher-level authorization; (b) "rules-based" systems involve a more tightly circumscribed set of parameters outlined in a detailed set of rules that are constant. Higher-level approval of specific transactions may be required, but this is in many cases limited to compliance with the rules themselves rather than the underlying merits of the transaction or the investment that is being funded.[40] These rules generally pertain to matters such as borrowing limits, purposes and uses of debt, and borrower risk limitations; (c) "direct-control" systems emphasize the ad hoc approval of specific municipal transactions by higher levels of government that have extensive discretionary powers with respect to the approval process.[41]

112. Most countries where municipal borrowing is permitted involve some mix of the approaches, with a bias towards one or the other, as further described in the materials in exhibit 10 of the annex. In recent years, the trend has been towards establishing either market-based or rules-based systems, as direct-control systems tend to be unpredictable and arbitrary and are not conducive to a significant expansion of the municipal market. Policy choices will be informed by a number of factors, including prevailing constitutional, institutional, and market realities, and it is not possible to design an appropriate system for any country without due consideration of such realities. However, it is possible to suggest that, where no system has yet been designed, or where regulatory measures suffer from obvious deficiencies, a concerted policy and legislative effort should be undertaken to design, reform, and strengthen the framework, drawing on the large store of international experience in this area. While the core responsibility lies with national and state governments, international agencies can make valuable contributions through the provision of technical assistance and support, as is discussed in the section addressing key actors above.

113. Systems and capacity-building are also important for implementation in the realm of borrowing. As with policy reform, capacity-building to promote municipal access to credit has key dimensions that are not credit-specific. For example, the roll-out of integrated financial management systems and the introduction of international accounting standards at the municipal level will be conducive to

[40] An exception would be Slovenia and Latvia, for example, where national commissions decide on the technical merits as well as the financial feasibility of municipal borrowing projects, based, of course, on published and operationalized rules.

[41] This framework is loosely based on the work of Teresa Ter-Minassian and others regarding subnational borrowing in general (see, for example, her IMF Paper on Policy Analysis 96/4, "Borrowing by Subnational Governments: Issues and Selected International Experiences" at http://www.imf.org/external/pubs/ft/survey/pdf/112596b.pdf). Note that the framework has been adapted for use with specific regard to municipal borrowing. This has material implications for the framework and particularly for the categorization of countries in terms of it.

investor interest in municipal credit opportunities. Such systems should be established both because of their intrinsic merits and because of their impact in expanding municipalities' access to credit. Also needed are systems and capacity-building measures focused specifically on expanding municipal access to credit.[42] Practically all countries in the developing market category require measures such as these, although naturally the specific requirements vary widely. A combination of national and state/provincial governments, municipalities themselves, international agencies, and technical support organizations will need to be mobilized in each country to provide the full range of systems and capacity-building initiatives that are needed.

114. Finally, national Governments, donor agencies, and other technical and advisory groups can consider a range of institutional initiatives that may accelerate the sustainable expansion of municipal debt markets. The risks and difficulties surrounding these initiatives have been highlighted. However, prudent, carefully considered measures can assist with achieving debt market expansion while avoiding the worst of these risks. Such measures could include the establishment of municipal lending intermediaries by a combination of private sector and donor groups outside of the state to avoid the difficulties that tend to be associated with state capitalized intermediaries.[43] In addition, the provision of credit enhancement mechanisms might ease investor concerns about municipal credit quality in nascent markets where the municipal sector is not well understood and perceived risk is considered to be higher than real risk. Such provisions could include, for example, limited guarantees and limited "first loss" reserve funds placed in escrow accounts that can be attached by investors in the case of default.[44]

Climate change

115. A number of elements can contribute to successful policy design, implementation, and monitoring of the priority areas in the realm of climate finance. Cities are leaders and innovators, but they also respond to the policy and financial incentives created by national Governments. Additionally, development banks, international governing bodies, and NGOs need to engage with national Governments to create financial incentives and policies that encourage cities to invest in lower-emission, climate-resilient infrastructure.

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[42] These can include measures to stimulate the development of secondary markets where securities can be traded among investors after initial issuance; measures to stimulate the provision of advisory services to municipalities for project preparation and loan transactions (e.g., a municipal infrastructure investment unit); measures to educate municipalities about the character and dynamics of loan finance and to help assist them to develop plans to become creditworthy (e.g., the creditworthiness academies run by the World Bank); measures to assist municipalities to take on the additional administrative responsibilities they will need to assume once they begin to borrow or expand their borrowing activity (e.g., debt management).

[43] INCA in South Africa, which functioned successfully as an entity of this kind in the 1990s and 2000s. One form of such intermediary is the local government funding agencies, increasingly prevalent in Europe, which pool the borrowing needs of local governments and issue bonds in capital markets, with the proceeds being on-lent to local governments.

[44] Examples of such initiatives which have had some success vary from specific enhancements provided by donors on a case-by-case basis to support "breakthrough" transactions (such as the USAID-provided guarantee of the Dakar bond which is still pending due to unresolved with the Ministry of Finance in Senegal) to institutions which focus purely on the provision of credit enhancement (such as CGIF in the Philippines).

116. National Governments can begin by using grants, matching funds, tax transfers, and preferential loan rates to support investment, and then use regulatory power to spur cities to set up frameworks and marketplaces that price externalities. These strategies would improve the risk-adjusted return for low-emission, climate-resilient infrastructure and change the financial calculus for cities. To make this recommendation a reality, donor funding will be needed to support the effort for a number of years. In order to maximize the cost-effectiveness of investments for climate resilience, actions at the city level should be encouraged that develop co-benefits such as mitigation of heat island effects, natural cooling and heating, dual use of recreational spaces, and reduction of noise and air pollution.

117. Additionally, frameworks to price climate externalities should be adopted. There are two types of climate externalities: (a) those that have a largely local impact, such as congestion, smog, and storm water run-off; and (b) those that have a largely dispersed global impact, such as carbon emissions. It can often be easier to build support for pricing local climate externalities, since their impact is closer to home. A variety of schemes already exist to help jurisdictions place value on local and global climate externalities to drive more efficient marketplaces. As at September 2015 39 countries and 23 cities, states, and provinces had employed carbon-pricing instruments, mostly in the form of carbon taxes or emissions-trading systems. Which system works best depends on the local context. For instance, trading systems tend to work better in places where there is a greater disparity in costs for various players to meet regulatory standards. In such places, actors with the greatest cost of meeting regulations are willing to pay for regulatory credits from those who find it less expensive to meet standards.[45] Cities can also be supported in restructuring their budgets so that they accurately value and internalize positive and negative climate externalities and attribute associated cash flows accordingly.

118. Project-preparation facilities that provide significant support to create "bankable" low-emission, climate-resilient projects should be well supported. To attract investment, projects must meet feasibility requirements and be based on a robust business case. By supporting infrastructure projects through early-stage development across functions such as feasibility, design, and project structuring, project-preparation facilities help address one of the major constraints for financing infrastructure: the lack of "bankable" projects. Project-preparation facilities and their financing partners can support low-emission, climate-resilient infrastructure in several ways: by changing project-selection criteria to favour low-emission, climate-resilient infrastructure; by conducting climate assessments and creating design recommendations to improve the sustainability aspect of traditional infrastructure projects; and by building the technical and financial capacity to advise on infrastructure that incorporates low-emission, climate-resilient technology.

119. Local financial institutions play an important role in climate finance and should have greater involvement. In the short term, multilateral development banks and other donors could expand their efforts to identify local financial

[45] For example, the city of Tokyo launched a successful cap-and-trade programme that allows firms to purchase credits permitting them to pollute from firms that voluntarily reduce their emissions. By the scheme's fourth year, emissions were reduced by 23 per cent compared with base-year emissions. Tokyo's long-term goal is to cut its carbon emissions by 25 per cent from 2000 levels by 2020.

intermediaries, while in the medium term, a number of reforms supporting these institutions, such as improving regulatory frameworks, could be made. By working with carefully selected intermediaries, donors may be able to increase project funding while simultaneously building the capacity of city governments. Intermediaries could share their knowledge and expertise with neighbouring institutions through forums or workshops, creating a new cadre of candidates for receiving concessionary capital for local low-emission, climate-resilient infrastructure projects. A number of underlying reforms could support a greater role for local financial institutions, such as improving capital markets and regulatory frameworks. Local financial institutions can benefit from improvements in local governments' fiscal resources and access to credit. Capacity-building within the institutions themselves can improve understanding of municipal and climate finance. Similarly, municipalities would benefit from building capacity for budgeting, fiscal management, and accountability.

120. Finally, support should exist for a laboratory or network of laboratories to identify and pilot new funding models. To address the additional challenges that cities face in pursuing low-emission, climate-resilient infrastructure projects, they need innovative forms of financing. Such innovations could include creating new instruments or funding models, adapting existing instruments or models for low-emission, climate-resilient infrastructure, or increasing access to existing instruments, models, and markets. A stand-alone urban-climate finance lab or series of networked labs could serve as the locus of these development efforts. It could use philanthropic, development bank, and concessionary capital to identify, pilot, and evaluate instruments, models, and mechanisms for financing urban infrastructure. The new lab or network of labs should identify and share financing practices with the potential to drive low-emission, climate-resilient urban infrastructure investment at scale, such as green bonds, long-term currency swaps, and risk guarantees. It could also build on existing initiatives and focus on piloting proven funding models and mechanisms in new market contexts or sectors. One or more labs could be set up by institutions with experience in urban development and infrastructure investment and access to concessionary funding.

Public-private partnerships

121. National Governments should encourage policy design, implementation, and monitoring that advances key components of what will enable P3s to succeed in several respects. First and foremost, it is important for localities to adopt a "users pay" principle for public infrastructure services where possible and appropriate. This will require establishing mechanisms like metering systems for water use or access and collection systems for toll roads. Without an established culture of users paying for the services provided by public infrastructure, it will be difficult if not impossible to capture the revenue needed to support a successful P3.

122. Additionally, national Governments should design P3 laws or regulations that ensure clarity of government policy on P3s. This policy framework can set rules regulating the creation of P3s and rules regulating the ongoing operation and maintenance of the partnership. For example, it should address logistical issues that indirectly impact the fundamental feasibility of a P3 (e.g., rules allowing a water utility to set water rates, but giving a higher level of government the authority to approve or change the rates). In addition, the framework might include policies for specific sectors and rules for the provision of public funds to close financial

viability gaps, where appropriate. The national policy framework should be supported by planning guidelines and manuals for forming P3s and should include drafted model P3 contracts. National Governments could establish a central P3 unit and/or sectoral P3 node to advise and assist municipalities to select, prepare, appraise, and negotiate P3 projects, to calculate the real cost of capital for a P3 compared with municipal debt, and to provide systematic training and capacity-building for municipalities.

VI. Conclusion

123. There is widespread agreement that cities across the developed and developing world are the key drivers of economic and social development for billions of citizens. Harnessing their potential, and ensuring their viable future, is a challenge of paramount importance. It requires recognizing that strong fiscal systems and supporting governance frameworks are critical to ensuring that strategic public investments go hand in hand with strategic funding mechanisms. National Governments play a pivotal role in this, with heightened importance in developing countries, where the gap between the availability of financial resources and municipal spending is rapidly widening as a result of urban population growth and the increasing demand for public services.

124. Operating from this understanding, this paper has coalesced conventional wisdom and academic literature with the practices and experiences of global experts and practitioners to identify gaps, policy options, and capacity issues relevant to addressing this challenge. It seeks to build a common understanding of the principles, finance instruments, and processes that are necessary to enhance the local revenue and finance conditions of cities. Identifying key elements that national Governments should implement to enable and empower local governments to effectively plan, and pay for, the future of their cities is urgently needed to align growth in cities in ways that fulfil the United Nations Sustainable Development Goals. Cities cannot succeed without strong fiscal strategies, and to that end, we close this paper with two final key messages that are critical to this dialogue.

125. First, a viable, strong, and responsible fiscal future requires that national Governments enable local governments to have access to significant sources of tax revenues as well as non-tax revenues (i.e., charges and fees). Revenue sufficiency and revenue diversity are key to a municipality's ability to deliver services to its constituents. It is also critically important that own-source revenues should be complemented by intergovernmental transfers that address the gaps in expenditure needs and fiscal capacity across cities. This — coupled with an enabling framework that allows the mobilization of revenue raising instruments like borrowing, public-private partnerships, and land value capture to support infrastructure investment — is critical to fiscal health. Together, these financing options should be enshrined in law, policy, and practice.

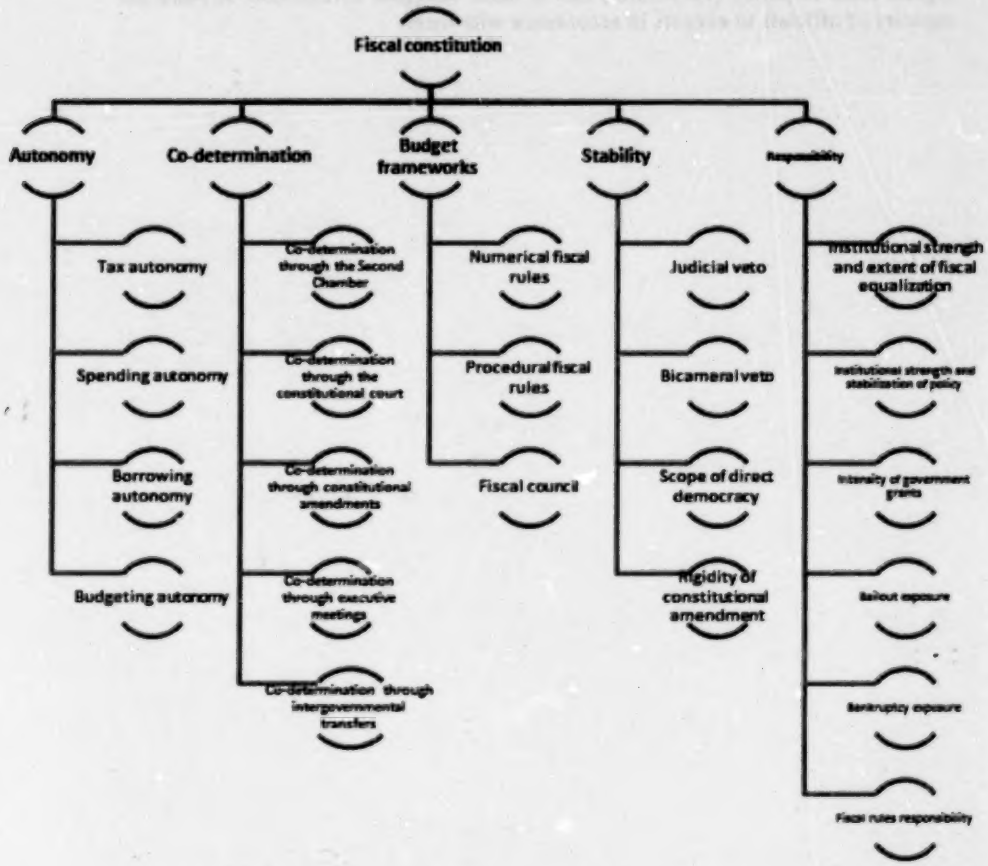
126. Second, building the foundation for a fiscal future that can fulfil the promise of the New Urban Agenda requires coalescing commitment, political will, and capacity for execution and reform among various layers of government — national, regional, and local — in these strategic areas. The strategies outlined in this paper cannot happen in a vacuum. They are shaped and influenced by the political dynamics, human capacity constraints, and realities of governance of each country,

as well as other local and national circumstances. Consensus at the national level regarding their importance, however, will heighten the likelihood that these principles will be ingrained in meaningful ways in regional and local policy and practice. Accordingly, achieving sound fiscal systems requires a framework of intergovernmental relations and cooperation. It must operate around a shared vision of the importance of these principles coupled with the commitment of leaders to ingrain them in policy (via reform) and to make adequate investments to build the capacity of officials to execute in accordance with them.

Annex

Exhibits

Exhibit 1
Elements of a fiscal constitution



Source: Organization for Economic Cooperation and Development.

Exhibit 2
Interactive policy matrix: municipal finance laws

Note: The matrix is also available at: https://goo.gl/Dw6grF.

Exhibit 3
Bahrain

Bahrain is an island kingdom with limited land availability. To ensure efficient utilization of land, Bahrain has developed a building permit system to create a systematic link between infrastructure planning and financial planning.

Recently, Bahrain has made it mandatory for all entities, private and public, to apply for building permits prior to commencing with any project. This includes local governments known as municipalities. The building permit application is a form which provides an overview of the project and consists of preliminary project data, plans and reports. Upon submission, the application along with any supporting documents, are circulated to all public infrastructure stakeholders electronically and their feedback is requested. This allows each entity to assess each project individually and confirm whether or not it is consistent with the national Government's development plans for their specific field. Each entity is required to respond to the building permit application with its comments regarding the feasibility of the project as submitted based on their inherent area of expertise. The responses of the Public infrastructure providers are available to the applicant instantly upon submission via the online platform. Additionally, the responses of each entity are available to all other public infrastructure stakeholders via the same platform allowing all entities the opportunity to read each other's responses thereby increasing the learning opportunities.

Municipal projects go through this same building permit system. The process acts as a communication mechanism ensuring there is constant communication between the local government and the national infrastructure providers with regards to implementation of ideas, upcoming plans and their feasibility. The building permit system ensures all projects that proceed to the development phase are deemed feasible by all public infrastructure stakeholders thereby greatly increasing the chance of any commenced project to be successful.

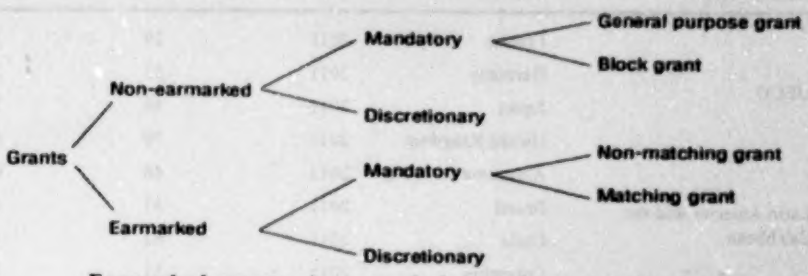
Exhibit 4
Fiscal decentralization: international comparisons for the 2000s

	Subnational government expenditures		*Subnational government taxes*	
Region	*Percentage of total government expenditures*	*Percentage of GDP*	*Percentage of total taxes*	*Percentage of GDP*
Developing countries	18.8 (16)	5.1 (20)	11.4 (16)	2.3 (20)
Industrial countries	27.8 (26)	13.9 (26)	22.7 (24)	6.4 (25)

Sources: Bahl, Linn, and Wetzel (2013); IMF (various years).
Note: Data reported are unweighted averages for the 2000s. The numbers in parentheses are the number of countries included in the comparison.

Exhibit 5
Fiscal transfers: grant typology

Intergovernmental grants are of many types. The diagram and text below provides a simple way of categorizing these.



Earmarked grants. An earmarked grant is a grant that is given under the condition that it can only be used for a specific purpose.

Non-earmarked grants. Non-earmarked grants can be spent as if they were the receiving subnational government's own (non-earmarked) tax revenues.

Mandatory grants. Mandatory grants (entitlements) are legal, rules-based obligations for the government that issues the grant. This requires that both the size of the grant and the conditions under which it is given be laid down in a statute or executive decree and that these conditions be both necessary and sufficient.

Discretionary grants. Discretionary grants, and the conditions under which they are given, are not determined by rules but decided on an ad hoc, discretionary basis. Discretionary grants are often temporary in nature and include, for example, grants for specific infrastructural projects or emergency aid to a disaster area.

Matching grants. Matching grants are grants designed to complement subnational contributions. Matching grants are dependent on normative or actual spending for services for which the grants are earmarked or on local revenue collection related to these services.

Non-matching grants. Non-matching grants are grants not directly linked to any subnational contribution.

Current grants. Current grants are grants assumed to be spent on either current or capital expenditures.

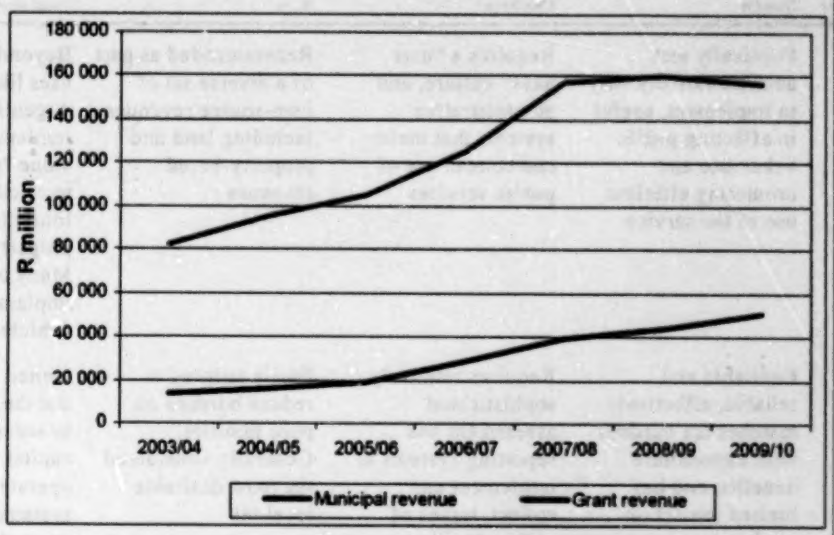
Capital grants. Capital grants are grants assumed to be spent only on capital expenditures.

Exhibit 6
Fiscal transfers: grants as a proportion of total municipal revenue — countries/region

Category/region	*Country*	*Data year*	*Fiscal transfers as a percentage of total municipal revenues*	*Fiscal transfers as a percentage of GDP*
OECD	France	2011	29	3.3
	Germany	2011	35	2.7
	Japan	2011	46	7.5
	United Kingdom	2011	70	8.7
Latin America and the Caribbean	Argentina	2013	48	0.7
	Brazil	2011	67	4.9
	Chile	2011	42	1.2
	Columbia	2011	51	3.2
	Kazakhstan	2011	61	5.9
Developing Asia	Indonesia	2010	85	4.5
	Mongolia	2011	8	0.3
	Thailand	2011	60	2.4
Africa	Côte d'Ivoire	2012	79	0.4
	Ghana	2012	80	0.7
	Kenya	2013	88	0.3
	Malawi	2013	75	0.9
	Nigeria	2013	98	2.2
	South Africa	2011	30	2.3
	Uganda	2011	93	3.3

Sources: Argentina Urban Diagnostic Report (Draft, World Bank, 2016); Côte d'Ivoire Urbanization Review (World Bank, 2015); Ghana Urbanization Review (World Bank, 2015); Government Finance Statistics Yearbook (IMF, 2012); Indonesia Local Government and Decentralization Project Appraisal Document (World Bank, 2010); Malawi Urban Development Report (World Bank, 2015); Nigeria Urbanization Review (World Bank, 2016); Uganda Inclusive Growth Policy Note (World Bank, 2015).

Exhibit 7
Fiscal transfers: increase in municipal transfers in South Africa



Source: National Treasury local government database

Exhibit 8
Own-source revenues typology

Local revenue sources	*Benefits*	*Challenges*	*Notes*	*Local examples*
User charges and fees	Politically and administratively easy to implement, useful in affecting public behaviour and promoting efficient use of the service	Requires a "user pays" culture, and administrative systems that meter and control use of public services	Recommended as part of a diverse set of own-source revenues, including land and property-based revenues	Beyond traditional uses like water fees, Argentine cities implement a land value "property fee" to circumvent limitations on property taxation. Many cities have implemented motor vehicle fees.
Property taxes	Equitable and reliable, effectively matches tax burdens with expenditure benefits, and has limited impact on market decisions	Requires relatively sophisticated assessment and reporting systems to implement and collect, issues of political will to implement	Easily tailored to reduce burdens on poor families. Generally considered the most desirable local tax	United States cities use the property tax to secure debt for capital investments, operate school systems, and supply general revenue streams
Land-based finance tools	Source of land-based capital to support investments and direct spatial growth	Generates single-use infusions of capital, but does not function as a sustainable revenue flow source	The core concept of "value capture" is the reclamation for public benefit of the increments in land value arising from public investments	Brazil uses CEPACS (the sale of density certificates) to fund infrastructure investments
Consumption taxes	Politically and administratively feasible to implement, captures economic growth	Regressive and volatile, requires caution to prevent multiplication of many small "nuisance taxes"	Recommended when paired with less-volatile land or fee-based revenues	Retail sales taxes and value added taxes make up a significant portion of local revenue streams. In Spain, they account for almost half of local revenues.

Source: World Bank Municipal Finance Handbook, 2014.

Exhibit 9

Own-source revenues: implementing value capture

The implementation of value capture tools involves a multipronged approach that includes educating policymakers on the legal and economic foundations of value capture, building capacity among local public officials to calculate and reclaim land value increments, and educating non-governmental stakeholders on the merits of sound land and urban development policies. Value capture more likely will succeed with the roll out of tools to reclaim land value increments when stakeholders understand that value capture promotes better performing land markets and reduces incentives for land speculation.

While there are numerous examples of successful uses in Latin America, there are several recurring themes and issues that need to be addressed to ensure a broader and more effective application of value capture. First, while value capture charges in theory are neutral regarding land use and should fall entirely on landowners, in practice successful implementation demands management skills to deal with many complex factors and diverse stakeholders. In addition, it requires proper understanding of land market conditions, comprehensive property monitoring systems, a fluid dialogue among fiscal, planning, and judicial entities, and the political resolve of local government leaders and planners. Land value increments are also captured more successfully when developers and other stakeholders perceive that the benefits accrued from value capture policies are an improvement over business as usual. Finally, value capture tools are more likely to succeed when used to solve a locally recognized problem.

More specifically, the following concrete guidelines should inform debates and practices around value capture globally:

- Ensure the proper timing of any proposed change from a traditional regulatory regime into one contemplating value capture tools that are appropriate to existing real estate market conditions
- Recognize that trial-and-error is part of the process of refining and institutionalizing any policy tool, including value capture, and that there is no one-size-fits-all solution
- Prioritize the public control of building rights and land uses rather than focus on state ownership of land as elements of a value capture strategy
- Maintain updated cadastres, valuation maps, and land and housing price records to generate the data needed to assess changes in land values
- Ensure administrative continuity in the implementation of value capture policies over time, especially for large-scale projects, to facilitate a less volatile environment that is more compatible with the maturation of long-term impacts
- Encourage direct negotiations between public officials and the private developers who will benefit from specific public actions

- Generate a willingness to pay when the benefit is perceived to be associated directly with the solution of a locally recognized problem
- Create a win-win situation resulting in significant land value increments being returned to a well-defined area as a result of public intervention

Countries and jurisdictions that have been able to innovate and expand upon land-based financial tools for revenue generation tend to enshrine the notion of the social function of land within key constitutional documents and legal codes. The principle of the social function of land establishes land as an essential collective good that requires protection and can justify some curbs on private property rights. It is this principle which helps establish the separation of building rights from landownership rights that is at the core of key revenue generating tools such as value capture.

Own-source revenues: financing African infrastructure with land value

For a long time, land has played a central role in financing urban infrastructure. Cities such as New York, London or Paris, and more recently Chinese cities, made it a major component for financing their urban infrastructures. By producing immediate substantial revenues, which significantly allows the reduction of the dependence on debt, the use of the various techniques of financing through land value capture appears well adapted to the cities witnessing a particularly fast urban growth.

Financing part of urban investments through land development still attracts little interest on the African continent. However, taking account of the enormous present and future needs, Africa will not be able to cope without this type of financing. The latter proves completely legitimate (collect the added value provided by public investments), and constitutes a type of financing with strong potential in cities with solid and regular space growth.

The special session held at the sixth Africities summit in Dakar in December 2012 highlighted the opportunities and obstacles of this method of financing, along with key reforms relevant to the African context:

- Reformation of land legislation, particularly relating to land tenure and land control by local government agencies
- Development of qualified specialized operators
- Establishment of an effective control framework to avoid missteps and the collection of revenue by the elites
- Development of tools necessary for urban management: strategic planning, citizen participation, geographical information systems, land registers, etc.

Exhibit 10

Municipal debt in mature and developing markets

State/local debt can be used as a proxy for municipal markets but because this data includes all subnational debt, including that of state/provincial governments in countries which have them, provides only an indication of municipal borrowing levels, and should be treated with caution. About 23 per cent of the total debt in advanced economies is held by subnational governments while in emerging and developing economies that figure is at 14 per cent. The importance of this market also tends to increase over time for advanced economies. State/local debt as a share of GDP increased from 16 per cent in 2002 for advanced economies. (Looking Beyond the Central Government — Global Trends in State and Local Government Debt IMF, 2014)

Disaggregated data for municipal borrowing specifically for samples of countries in mature and developing markets is provided in the tables below.

Mature municipal debt markets — debt as percentage of GDP

Country	*2009*	*2010*	*2011*	*2012*	*2013*
France	8.43	8.54	8.55	8.79	8.96
Netherlands	8.19	8.68	8.91	9.22	9.32
Spain	3.32	3.38	3.51	4.27	4.12

Source: Local government debt, Governance Finance Statistics Database, IMF, downloaded February 2016.

Developing municipal debt markets — debt as percentage of GDP

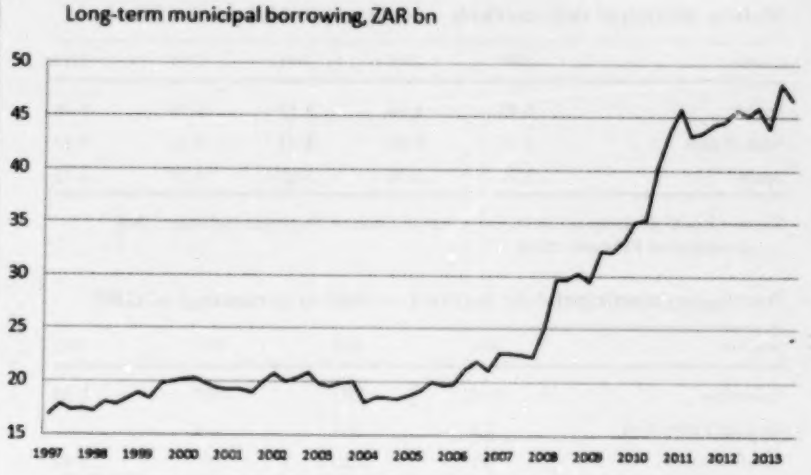
Country	*2009*	*2010*	*2011*	*2012*
Colombia	0.94	0.93	0.97	0.84
Russian Federation	2.3	3.1	2.8	2.6
South Africa	1.17	1.28	1.43	1.40

Source: Colombia Governance Finance Statistics Database, IMF, downloaded February 2016; Russian Federation: Subnational Debt Management and Restructuring, World Bank 2015; South Africa "Municipal Borrowing and Urban Infrastructure Finance", World Bank, September 2014.

Exhibit 11

Municipal borrowing activity in South Africa

South Africa demonstrates a clear case of a developing municipal debt market country where regulatory reform and support of a range of "municipal borrowing ecosystem" activities has underpinned a significant expansion of sustainable borrowing. A range of policy formulation and legislative activities was undertaken in the late 1990s and early 2000s which, among other things, established a robust, market-oriented regulatory framework for municipal borrowing and consolidated certain fundamentals regarding the revenue powers and financial management requirements pertaining to municipalities. These culminated in the passing of the Municipal Financial Management Act and various other pieces of related legislation by 2004, following which borrowing activity grew significantly — and continues to grow — as indicated in the graph below. It should be noted that, by law, municipal debt may not be guaranteed by central Government.

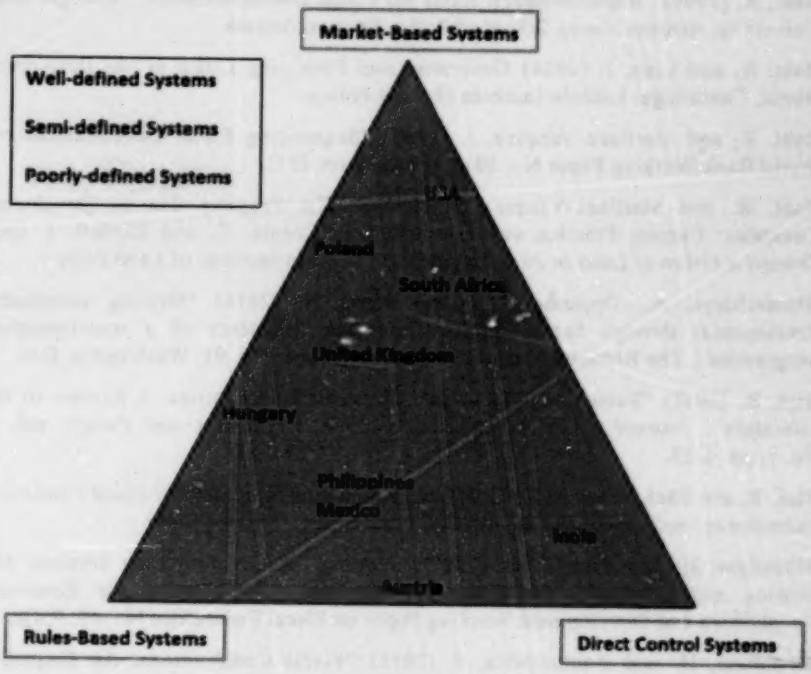


Source: "Municipal Borrowing and Urban Infrastructure Finance", World Bank, September 2014

Exhibit 12

Regulatory systems for municipal borrowing — various countries

Regulatory frameworks for municipal borrowing are of three kinds: market-based systems; rules-based systems; and direct control systems. Most countries tend to combine these three approaches, albeit with some sort of bias. And any given system is more or less well defined and stipulated in policy, law and regulation. The diagram below gives a sense of where a sample of countries stand in the three kinds of regulatory frameworks noted.



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